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No. 91-

Supreme Court, U.S.
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IN THE
Supreme Court of the United States
OCTOBER TERM, 1991

ERNST & YOUNG,
Petitioner,
v.
BOB REVES, *et al.*,
Respondents.

Petition for a Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

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PETITION FOR A WRIT OF CERTIORARI

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QUESTIONS PRESENTED

1. In a private action for damages under Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), whether this Court's decision in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972), entitles a plaintiff class of securities purchasers to a presumption of reliance on a defendant's factual omissions, even though plaintiffs never alleged that they received the financial statements or heard the oral presentations in which the omissions were made or that they otherwise relied on any conduct of the defendant in making their investment decisions.

2. Whether, in holding petitioner liable under Section 106(c) of the Arkansas Securities Act, Ark. Stat. Ann. § 23-42-106(c), under a theory of liability that was necessarily based on factual findings never made by the district court, never presented to the jury, and not otherwise supported by the record, the court of appeals so far departed from the accepted rules of appellate review as to call for the invocation of this Court's supervisory powers.

PARTIES TO THE PROCEEDING

In addition to the parties listed in the caption, in the proceedings below Frances Graham was a plaintiff/appellee and plaintiff/cross-appellant. Robert H. Gibbs appeared individually as a plaintiff/appellee, and he appeared as a plaintiff/cross-appellant in three separate capacities: (i) individually, (ii) as natural guardian of his minor children, Thomas A. Gibbs and Robert H. Gibbs, Jr., and (iii) as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds. Thomas E. Robertson, Jr., as trustee of the Farmer's Co-op of Arkansas and Oklahoma, Inc., and as representative of a class of members, depositors, and equity security holders, appeared as a plaintiff/appellee and plaintiff/cross-appellant; and Robert R. Cloar, Class Counsel, was an appellant.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-69a) is reported at 937 F.2d 1310. The pre-trial opinion of the district court (Pet. App. 70a-121a) considering various defendants' motions to dismiss is reported at 633 F. Supp. 954. The pre-trial opinion of the district court (Pet. App. 122a-229a) granting in part and denying in part petitioner's motion for summary judgment is unreported. The post-trial opinion of the district court (Pet. App. 232a-292a) denying petitioner's motion for judgment notwithstanding the verdict is unreported.

JURISDICTION

The judgment of the court of appeals was entered on June 27, 1991 (Pet. App. 4a), and a timely petition for rehearing was denied on August 29, 1991 (Pet. App. 303a). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATUTORY PROVISIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, and Section 106 of the Arkansas Securities Act, Ark. Stat. Ann. § 23-42-106,[1] are reproduced at Pet. App. 304a-306a.

STATEMENT

1. *The Co-op And Its Demand Note Program.* This case arises out of the 1984 bankruptcy of the Farmer's Cooperative of Arkansas and Oklahoma, Inc. ("Co-op"). The Co-op was organized in 1946 and was conducting extensive business operations in western Arkansas and eastern Oklahoma by the late 1970's. Beginning in 1959, the Co-op raised capital to support its general business operations by selling promissory notes payable on demand of the holder. These demand notes were uncollateralized and

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[1] At the time this case was tried, this section was codified as Ark. Stat. Ann. § 67-1256.

uninsured, but were attractive to investors because they paid a higher rate of interest than the rates offered by local financial institutions. Pet. App. 7a. The Co-op advertised the demand note program in its monthly newsletter. The advertisement stated that "YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] insured but it is * * * Safe * * * Secure * * * and available when you need it." C.A. Jt. App. 1820 (ellipses in original).

2. *Arthur Young's Audits.* Arthur Young & Company was first retained as the Co-op's independent auditor in 1981.[2] It subsequently issued audit reports on the Co-op's financial statements for the years ending December 31, 1981 and December 31, 1982. Upon assuming its duties as the Co-op's auditor, Arthur Young was required to address a number of accounting issues. One major issue was evaluating the carrying value of a gasohol plant that was owned by the Co-op through its wholly-owned subsidiary, White Flame Fuels, Inc. ("White Flame").

In 1979, the Co-op's general manager, Jack White, had joined with another individual to finance and construct the gasohol plant. Beginning in January 1980, White obtained loans from the Co-op to finance the continued construction and the initial operation of the gasohol plant. White personally guaranteed these loans. The plant began producing gasohol in April 1980, but was soon beset by problems stemming from its poor design and from economic factors such as the falling price of oil. White continued to obtain loans from the Co-op to cover the plant's operating costs. By December 1980, the loans totalled approximately $4 million. Eventually, the Co-op's board of directors voted to purchase all of the stock of White Flame in exchange for the Co-op's assumption of White's $4 million debt. Pet. App. 7a-9a.

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[2] In 1989, Arthur Young and Ernst & Whinney combined to form the firm of Ernst & Young, which is the petitioner in this case. Because the events at issue occurred prior to 1989, we will refer to petitioner as Arthur Young.

The proper accounting treatment for the gasohol plant depended on whether the Co-op had owned the plant from the beginning of its construction. If so, the plant could be carried at historical cost, approximately $4.5 million net of depreciation. If not, the proper carrying value would have been the fair market value of the plant at the time of transfer, which subsequently was estimated to have been between $444,000 and $1.5 million. Pet. App. 14a & n.7. Although the stock of White Flame was originally owned by White and his partner, Arthur Young concluded that the Co-op's carrying the plant at its historical cost of $4.5 million would not violate generally accepted accounting principles ("GAAP") because the plant had been constructed primarily with funds borrowed from the Co-op. *Id.* at 12a-15a, 20a. Because the Co-op's balance sheets for 1981 and 1982 reflected a net worth of only $2.6 million and $1.3 million, respectively, carrying the plant at its fair market value instead of historical cost would have resulted in the Co-op's balance sheets showing a negative net worth. *Id.* at 15a, 20a.

Although Arthur Young concluded that carrying the gasohol plant at its historical cost would not violate GAAP, it also concluded, because of uncertainty over the recoverability of the cost of the plant, that it could not express an opinion on whether carrying the plant at historical cost fairly presented the financial condition of the Co-op. Arthur Young therefore issued qualified opinions on both the 1981 and 1982 financial statements. The 1981 audit report stated that:

> As discussed in Note 9 to the consolidated financial statements, there is some doubt as to the recoverability of the investment in the gasohol plant of White Flame Fuels, Inc. and its continuing operations. Management has not prepared projections and other analyses to assess the potential recovery of this investment. Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated financial statements.

C.A. Jt. App. 235; Pet. App. 14a.

Footnote 9 to the Co-op's financial statements addressed the accounting for the gasohol plant and the economic prospects of the Co-op:

> Financing of the initial construction and subsequent revisions which totaled approximately $4,522,000, was provided by the Co-op. Also, from the initial start of production through December 31, 1981, the Co-op has provided operating capital for White Flame. As of December 31, 1981, the Co-op had an investment of approximately $5,830,000 in White Flame. The ability of the Co-op to continue providing funds to cover operating losses of White Flame Fuels, Inc. (currently averaging $100,000 per month) until such time that improvements in market conditions and production efficiency permit profitable operations are not determinable. The combination of factors as mentioned above, which must result favorably, cast doubt on the recovery by the Co-op of its investment in White Flame Fuels, Inc. and the recovery by White Flame Fuels, Inc. of its investment in plant and equipment on the basis of a going concern. Projections and other analyses have not been prepared by management in order to assess the potential recoverability of this investment.

C.A. Jt. App. 251-252; Pet. App. 15a.[3]

The audited financial statements also revealed other negative information concerning the Co-op's financial condition. In particular, they indicated that the Co-op's current liabilities were approximately double its current assets and that the Co-op had suffered net losses of $1.4 million in 1981 and $1.2 million in 1982. C.A. Jt. App. 238-240, 261-263. Since 1955, the Co-op had suffered a net loss on only one previous occasion—a loss of $138,536 in 1967. *Id.* at 231. Arthur Young presented its audit

[3] Arthur Young's audit report on the Co-op's 1982 financial statement contained the same qualification as its 1981 report, and the 1982 financial statements themselves, in footnote 8, provided updated information on White Flame's worsening financial condition and the resulting uncertainty about the Co-op's ability to recover its investment. C.A. Jt. App. 258, 272-273; Pet. App. 19a-20a.

reports to the Co-op's board, but there is no evidence that the Co-op ever distributed the audit reports or audited financial statements to Co-op members or note holders.

3. *The 1982 and 1983 Annual Meetings And Condensed Financial Statements.* In addition to issuing the audit reports, representatives of Arthur Young gave oral presentations on the financial condition of the Co-op at its annual meetings in May 1982 and March 1983. At these meetings, condensed financial statements prepared by the Co-op were distributed to the audience. At the beginning of their oral presentations, Arthur Young's representatives informed the members of the audience that they had received only condensed financial statements and that copies of the full audited statements were available at the Co-op's offices. Pet. App. 17a, 21a. The record does not indicate that anyone ever asked to see the audited financial statements. The condensed financial statements did not include the qualifications in Arthur Young's audit reports or the footnote disclosures concerning the gasohol plant. *Id.* at 16a, 21a.

The condensed statement of operations handed out at the 1982 meeting did not incorporate the gasohol plant operations and therefore reflected a net profit of $154,000. C.A. Jt. App. 231. The condensed balance sheet included the gasohol plant valued at historical cost and therefore reflected net members' equity of $2.6 million. Pet. App. 16a. During the course of the oral presentation by Arthur Young's representative, the audience soon began asking questions concerning White Flame and its financial status. During these interchanges, White Flame's $1.2 million dollar loss in 1981 was disclosed to the audience. The meeting became very heated, with the audience asking many questions about White Flame and other items in the condensed financial statements. As the questions increased in both frequency and intensity, Arthur Young's representative was unable to respond and the Co-op's board moved the meeting on to the next item on the agenda. *Id.* at 17a.

At the 1983 annual meeting, the Co-op distributed condensed financial statements that more completely presented the Co-op's rapidly worsening financial condition. However, they again did not contain the qualification in Arthur Young's audit opinion or the footnote disclosure on the gasohol plant. Pet. App. 20a. The condensed statement of operations for the 1983 annual meeting did include the gasohol plant and reflected losses of $1.4 million in 1981 and $1.2 million in 1982. C.A. Jt. App. 233. In addition, the balance sheet reflected current assets of only $6.9 million to cover current liabilities of $15.3 million. *Id.* Net members' equity had dropped from $2.6 million to $1.3 million. *Id.* The oral presentation of Arthur Young's representative at the 1983 meeting lasted only about three minutes. Pet. App. 21a.

4. *The Co-op's Bankruptcy.* In addition to the demand notes, the Co-op relied on funding from the Cooperative Finance Association ("CFA"), which had provided loans and lines of credit to the Co-op. Because of the Co-op's reliance on demand notes, CFA had informed the Co-op that if the amount of invested notes dropped below $9.5 million, CFA would cut off the Co-op's line of credit. In February 1984, the aggregate demand notes dropped slightly below $9.5 million, and CFA refused to advance additional funds on the line of credit. On February 23, 1984, the Co-op filed for bankruptcy. Pet. App. 21a-22a.

5. *The Proceedings Below.* Less than a year later, the Co-op's bankruptcy trustee filed an action in the United States District Court for the Western District of Arkansas on behalf of the Co-op and certain demand note holders against forty individuals and entities, including Jack White, members of the Co-op's board, several of the Co-op's lawyers, Arthur Young, and the two auditors that had preceded Arthur Young. The complaint alleged a wide variety of federal and state causes of action, including common law fraud, violations of the registration and disclosure provisions of the Arkansas Securities Act, violations of Section 10(b) of the Securities Exchange Act of 1934 ("1934 Act"), and violation of the Racketeer

Influenced and Corrupt Organizations Act, 18 U.S.C. §§ 1961-68. Subsequently, the district court certified a class consisting of persons who purchased demand notes between February 15, 1980, and February 23, 1984, and named Bob Reves, Frances Graham, and Robert Gibbs as the class representatives. Pet. App. 23a.

Prior to trial, all defendants except Arthur Young and White's lawyers settled the claims against them. Pet. App. 23a.[4] In addition, the district court dismissed or granted Arthur Young summary judgment on all of the Class' claims against it other than the Section 10(b) claims and claims that Arthur Young was secondarily liable for disclosure violations of the Arkansas Securities Act. Arthur Young requested summary judgment on the Section 10(b) claims on the basis that "no one specifically relied on any of its representations concerning the financial status of the Co-op." Pet. App. 209a. Although the district court granted summary judgment to Arthur Young on the Class' common law fraud claims because the "record [did] not permit a finding of the specific kind of reliance required by the common law precedents in this state or others" (*id.* at 191a), the district court did not grant summary judgment on the Section 10(b) claims. While noting that "Rule 10b-5 at least arguably requires a showing of reliance missing from plaintiffs' proofs," the district court determined that it would reserve judgment on the issue until after trial. *Id.* at 215a.

After a month-long trial, the district court gave the following instruction to the jury on the issue of reliance:

> [I]n order to satisfy this element, the Class need not prove that the Class actually relied on defendant's conduct. Rather, plaintiff's [sic] can satisfy his burden if he proves that the defendant sought to be charged omitted to state a fact to him, and that the omitted fact was material.

Pet. App. 42a n.23.

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[4] White's lawyers settled after trial. Pet. App. 23a n.13.

The jury found that Arthur Young had committed primary violations of Section 10(b) and secondary violations of the Arkansas securities statute. Pet. App. 25a. The jury awarded damages of $6.1 million to members of the Class who purchased demand notes between April 22, 1982, the date Arthur Young submitted its first audit report to the Co-op's board, and February 23, 1984, the date the Co-op filed for bankruptcy. *Id.* at 56a. In its motion for judgment notwithstanding the verdict, Arthur Young reasserted its argument that there was no evidence that any member of the Class relied on any representation made by Arthur Young. *Id.* at 281a. The district court decided, however, that the Class was entitled to a presumption of reliance on factual omissions under this Court's decision in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-154 (1972). Pet. App. 286a. With respect to secondary liability under the Arkansas Securities Act, the district court did not find that Arthur Young fell within any of the classes of persons enumerated in the statute as having secondary liability, but held that anyone who would have been liable as a joint tortfeasor at common law could also be secondarily liable under the Act. *Id.* at 270a-271a.

Both Arthur Young and the Class appealed the district court's judgment to the United States Court of Appeals for the Eighth Circuit. In its first opinion in this case, the court of appeals held that the demand notes were not securities under federal and Arkansas securities laws and reversed the district court's judgment. *Arthur Young & Co. v. Reves*, 856 F.2d 52 (1988). This Court granted certiorari and reversed the judgment of the Eighth Circuit, holding that the demand notes were securities under the 1934 Act. *Reves v. Ernst & Young*, 110 S. Ct. 945 (1990).

On remand, the court of appeals concluded the demand notes also were securities under Arkansas law and affirmed the district court's judgment that Arthur Young had committed primary violations of Section 10(b) and was secondarily liable for violations of the Arkansas

Securities Act. The Eighth Circuit reversed the district court's judgment, however, on the issues of damages, settlement credits, and attorneys' fees and remanded for further procedings on these issues. Pet. App. 69a.

Arthur Young's primary argument to the court of appeals was based on the failure of the Class to present any evidence that there had been any communication between Arthur Young and any member of the Class. Throughout the litigation, the Class tried to pass off statements made by Arthur Young's representatives at the Co-op's annual meetings as statements that had been made by Arthur Young *to the Class*. However, there is no evidence in the record that any of the class members ever (1) received the audited financial statements, or (2) attended one of the annual meetings. Conversely, there is no evidence that any individual who saw the audited financial statements or attended the annual meetings thereafter purchased demand notes. Because of this absence of any connection between anything the class members saw or heard and Arthur Young's conduct, Arthur Young argued that the Class members could not have relied on Arthur Young in purchasing the demand notes.

The court of appeals acknowledged Arthur Young's argument in passing (Pet. App. 41a), but nevertheless held that the Class was entitled to a presumption of reliaance under *Affiliated Ute*. Although "recogniz[ing] that there is some analytical difficulty in separating misrepresentations from nondisclosures" (Pet. App. 42a), the court of appeals agreed with the district court that the case involved primarily nondisclosures. In addition, the court found that Arthur Young owed the Class a duty to disclose under a seven-factor "flexible duty" test. *Id.* at 45a & n.26. However, none of the factors identified by the court of appeals encompassed consideration of the question whether there was any factual connection between the class members' investment decisions and Arthur Young's conduct. *Id.*

Although the Eighth Circuit also affirmed the district court's finding of secondary liability under Section 106(c)

of the Arkansas Securities Act, it disagreed with the district court's use of common law theories to reach that result, referring to them as "an amalgam of rather tenuous theories." Pet. App. 35a. Instead, the court of appeals found Arthur Young liable under Section 106(c) on the ground that it had materially aided in the sale of the securities. *Id.* at 34a. Although Section 106(c) explicitly limits the categories of persons who can be secondarily liable for materially aiding in the sale of a security to employees of the seller, broker-dealers, and agents (as defined in the statute), the Eighth Circuit did not, and apparently could not, specify within which, if any, of the statutory categories it considered Arthur Young to fall.[5]

REASONS FOR GRANTING THE PETITION

This case squarely presents the issue of whether reliance should remain a separate and essential element of all private actions for damages under Section 10(b). The Eighth Circuit held that the Class was entitled to a "presumption" of reliance even in the absence of an allegation that Class members had ever heard or saw anything that Arthur Young said or did prior to making their investment decisions. In so doing, the Eighth Circuit fundamentally misconstrued this Court's decision in *Affiliated Ute*. In that case, this Court neither dispensed with reliance as an essential element of a Section 10(b) action nor created a presumption of reliance in the absence of evidence indicating that it was logical to do so. Rather, the Court explicitly found that plaintiffs had relied on defendants when they sold their stock, and this finding was one of the essential circumstances that rendered positive proof of reliance on specific factual omissions unnecessary.

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[5] Although the Class had previously alleged that Arthur Young was a "control person" under the Act, the court of appeals did not rest its decision on that ground and in fact suggested otherwise. Pet. App. 34a. ("We note in passing that Arthur Young certainly did not direct the Co-op's operations.").

In granting a presumption of reliance even when there was no reason to believe that the Class had actually relied on Arthur Young, the Eighth Circuit adopted a position that directly conflicts with the congressional determination that reliance should be an essential element of the express rights of action under the 1934 Act. This Court should grant certiorari in order to affirm that *Affiliated Ute* was not intended to provide a means to circumvent this fundamental policy determination.

The Court also should grant review in order to address the court of appeals' unwarranted departure from accepted rules of appellate procedure in affirming the district court's judgment of liability under the Arkansas Securities Act. While the court of appeals rejected the district court's legal theories, it nevertheless found Arthur Young liable under a provision of the Act that would apply only if Arthur Young were an "employee" of the Co-op, a "broker-dealer," or an "agent," as defined in the Act. The factual findings necessary to support liability under any of these three categories were not made by the district court or presented to the jury, and such findings are not otherwise supported by the record. Consequently, the court of appeals' action sufficiently departed from accepted rules of appellate procedure that this Court should exercise its supervisory power over the federal judiciary and grant this petition in order to reverse or remand for further proceedings.

I. THE COURT SHOULD AFFIRM THAT SECURITIES PLAINTIFFS ARE NOT ENTITLED TO A PRESUMPTION OF RELIANCE ON A DEFENDANT'S OMISSIONS OF PARTICULAR FACTS WHEN THEY HAVE NOT ALLEGED RELIANCE ON ANY CONDUCT OF THE DEFENDANT IN MAKING THEIR INVESTMENT DECISIONS

The Court has held that reliance is an essential element of a private action for damages under Section 10(b). *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988). This holding was based in part on a congressional determination that under the express causes of action provided by

the 1934 Act "the burden is on the plaintiff to show the violation or the fact that the statement was false or misleading, *and that he relied thereon to his damage*." S. Rep. No. 792, 73d Cong., 2d Sess. 13 (1934) (emphasis added). *See Basic*, 485 U.S. at 243 (citing *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976), in which the Court quoted the above-referenced passage from the Senate Report on the 1934 Act). The importance of the reliance requirement was further emphasized by the Chairman of the House committee responsible for the 1934 Act: "[T]he bill as originally written was very much challenged on the ground that reliance was not required. This objection has been met." Statement of Rep. Rayburn, 78 Cong. Rec. 7701 (1934); *see also Basic*, 485 U.S. at 258 (White, J., dissenting) ("Congress thus anticipated meaningful proof of 'reliance' before civil recovery can be had under the Securities Exchange Act.").

Our primary contention in this case is that the court of appeals seriously misconstrued this Court's decision in *Affiliated Ute* when it granted a presumption of reliance to plaintiffs who had not alleged that they either saw Arthur Young's audit reports or attended the Co-op's annual meetings at which Arthur Young's representatives made oral presentations. Throughout the lower court proceedings, the Class has attempted to obscure this core issue by intimating that the persons who attended the annual meetings are the same persons to whom Arthur Young was held liable. In fact, however, the record demonstrates no such thing.

To bring the issue in this case into sharper relief, Arthur Young acknowledges that it would have been appropriate to presume reliance on its alleged omissions by anyone who attended the annual meetings. Arthur Young submits, however, that granting a presumption of reliance on factual omissions to those who have not alleged reliance on *any* conduct of the defendant stretches this Court's holding in *Affiliated Ute* far beyond reasonable bounds and directly conflicts with the congressional de-

termination that reliance should be an essential element of a plaintiff's burden of proof.

A. The Court In *Affiliated* Ute Made An Explicit Finding That Plaintiffs Had Relied On Defendants When They Sold Their Stock, And This Finding Was One Of The Essential Circumstances That Rendered Positive Proof Of Reliance On Omissions Of Particular Facts Unnecessary

The Court's opinion in *Affiliated Ute* clearly shows that the Court neither dispensed with reliance as an element of a Section 10(b) action nor granted a presumption of reliance in the absence of evidence affirmatively indicating that it was logical to do so. Rather, the Court made an explicit finding that the plaintiffs had relied on defendants when selling their securities, 406 U.S. at 152, and this finding was one of the circumstances that provided the context for the following passage:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

406 U.S. at 153-154 (citations omitted).

Based on this passage, the court of appeals approved a jury instruction stating that the Class need not prove it actually relied on Arthur Young's conduct.[6] But this interpretation of *Affiliated Ute* can be supported only by reading the paragraph dispensing with "positive proof of reliance" in isolation. As discussed below, the immedi-

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[6] The Eighth Circuit is not alone in its view that the reliance requirement has been eliminated in nondisclosure cases under Section 10(b). *See* 5A A. Jacobs, *Litigation and Practice Under Rule 10b-5*, § 62 at 3-254 (2d ed. 1991 rev.) ("the Supreme Court and other tribunals no longer require the element of reliance in 10b-5 concealment cases").

ately preceding nine pages of the Court's opinion describe the factual context for the failure to disclose and compellingly demonstrate that plaintiffs had actually and directly relied on defendants' conduct. Only reliance on omissions of particular facts was presumed; reliance on the conduct of defendants was manifest in the context of how the factual omissions were made.

The plaintiffs in *Affiliated Ute* were members of an Indian tribe who had received shares of stock in a corporation ("UDC") holding tribal assets. In order to protect the Indian stockholders, who were unsophisticated investors, UDC had imposed a number of unusual conditions on sales of its stock. Indians desiring to sell their stock were required to give first-refusal rights to other Indians, and sales could be made to non-Indians only if no Indian accepted the offer. 406 U.S. at 137 & n.7. One of the defendants in *Affiliated Ute* was a bank retained by UDC to act as transfer agent for UDC stock. *Id.* at 145. Two other defendants were assistant managers of a branch of the bank located in an area where many of the Indian stockholders resided. *Id.* at 146. The bank, primarily through the two managers, handled the documents implementing the first-refusal procedure. *Id.* at 147. Moreover, the bank had acknowledged to UDC that it had a duty to see that the transfers were properly made and that it would be acting for the Indian stockholders. *Id.* at 152. The Court specifically noted that Indians who contemplated the sale of their shares were "*compelled to deal through the bank.*" *Id.* at 145 (emphasis added).

The Court found that the bank managers had devised a plan or scheme to acquire, for themselves and others, UDC shares from Indians and were active in encouraging a market for the UDC stock among non-Indians. 406 U.S. at 152-153. They solicited and accepted standing orders from non-Indians and were entirely familiar with the prevailing market for the stock at all material times. *Id.* at 152. The managers received various commissions and gratuities for their services in facilitating the transfer of UDC stock from Indians to non-Indians. *Id.* Most im-

portantly for present purposes, the Court specifically found that the Indians "considered these defendants to be familiar with the market for the shares of stock and *relied upon them when they desired to sell their shares.*" *Id.* (emphasis added) (citation omitted).

In sum, the facts overwhelmingly demonstrated direct reliance by Indian stockholders on the conduct of the defendant bank and its managers, who had used their unique position with respect to the Indian plaintiffs' interest in the UDC stock to prey upon unsophisticated investors for the defendants' direct personal benefit. Yet the managers never told the Indians that there was another market for their UDC shares, in large part developed and encouraged by the defendants themselves, and that UDC shares sold for a higher price in that market than the Indians were receiving. 406 U.S. at 153. These were the circumstances that provided the basis for the Court's holding that, "[u]nder the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery." *Id.*

The primary cases cited by the Court in *Affiliated Ute* support the notion that the plaintiff must show *some* form of reliance on the defendant's conduct before reliance on omissions of particular facts may be presumed.[7] For example, the Court cited (406 U.S. at 154) *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (2d Cir. 1970), for the proposition that a defendant's nondisclosure when under a duty to disclose demonstrates causation in fact. In *Chasins*, however, the court specifically noted that the plaintiff had relied on his securities broker's conduct. *Id.* at 1172.

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[7] The importance of reliance on defendants' conduct is also evidenced by the Court's discussion of *Affiliated Ute* in *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (emphasis added): "The Court recognized that no duty of disclosure would exist if the bank merely had acted as a transfer agent. But the bank also had assumed a duty to act on behalf of the shareholders, *and the Indian sellers had relied upon its personnel when they sold their stock.*"

Similarly, in *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970), the defendant had sent proxy statements containing misleading omissions to its shareholders seeking their approval of a proposed merger. Thus, the issue was not whether the shareholders had received the document containing the misleading omissions—evidencing reliance on the conduct of the defendant—but whether the specific factual omissions in the proxy statement should be presumed to have influenced the voting process. *Id.* at 384-385. Under these circumstances, the Court held that the requisite causal nexus between the omission and the plaintiffs' injury was adequately established by proving that "the proxy solicitation itself, rather than the particular defect in the solicitation materials, was an essential link in the accomplishment of the transaction." *Id.* at 385. Again, the Court allowed plaintiffs to dispense with proof of reliance on factual omissions, but only in the face of evidence strongly indicating that it was logical to do so because the plaintiffs had received defendants' proxy solicitation.[8]

Properly understood, therefore, *Affiliated Ute* does not permit reliance on omissions of particular facts to be presumed unless the circumstances demonstrate that such a

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[8] In *Affiliated Ute*, the Court also cited an insider trading case, *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968), *cert. denied, sub nom. Coates v. SEC*, 394 U.S. 976 (1969). As the Court has subsequently recognized, however, insider trading cases are conceptually distinct from cases where, as here, the defendant did not trade. In insider trading cases, the element of deception "derives from the 'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'" *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (quoting *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)). The peculiar nature of the deception also serves to define the scope of liability for insider trading violations, which is typically limited to contemporaneous traders of the defendant and to the unlawful profits made by the defendant. *See, e.g., Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 94 (2d Cir. 1981) (contemporaneous traders); *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 172 (2d Cir. 1980) (disgorgement of unlawful profits).

presumption is rational because plaintiffs have relied on defendants' conduct. As discussed next, however, the courts of appeals have reached differing conclusions on this issue.

B. The Courts Of Appeals Have Not Agreed On Whether *Affiliated Ute* Authorizes A Presumption Of Reliance On Factual Omissions In The Absence Of Any Showing That Plaintiffs Relied On Anything That Defendants Said Or Did

The Seventh Circuit has recognized that *Affiliated Ute* was not intended to provide an excuse to "presume" reliance in the absence of any evidence indicating that it is logical to do so. Consequently, it has held specifically that plaintiffs are not entitled to invoke the *Affiliated Ute* presumption when they have not alleged that they read or relied on the document containing a defendant's omissions of material facts. In *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322, 1325 (7th Cir. 1989), a group of investors alleged that an accounting firm's audit report contained misleading omissions, but they did not "claim to have relied on the 1982 audit report or even to have read it." The court of appeals cogently identified the fundamental flaw in plaintiffs' allegations:

> Where misrepresentations are made but not relied on directly or indirectly (we are a about to turn to the indirect case [the fraud-on-the-market theory]), a plaintiff in a fraud case cannot show that he was harmed by them. When what is charged is not misrepresentation but omission, the word "reliance" is awkward and it is better to speak of the plaintiff's having been misled to his detriment. [citing *Affiliated Ute*] Although the plaintiffs in this case allege both misrepresentations and deceptive omissions by Laventhol & Horwath, they do not allege that these misrepresentations and deceptive omisisons misled or deceived *them*.

876 F.2d at 1326.[9]

[9] Similarly, in *Ross v. Bank South, N.A.*, 885 F.2d 723, 728 (11th Cir. 1989), *cert. denied*, 110 S. Ct. 1924 (1990), the Eleventh Cir-

As aptly stated by the Seventh Circuit, when plaintiffs have not alleged that they relied on any conduct of the defendant, the missing element of deception logically precludes application of the *Affiliated Ute* presumption of reliance. The court below, however, as well as the Second, Ninth, and Tenth Circuits, have not agreed with this analysis and have extended this Court's holding far beyond recognition. For example, the Second Circuit, in a case with remarkably similar facts to *Latigo Ventures*, reached an opposite result. In *Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F.2d 811 (2d Cir. 1975), the court held that the plaintiff need not prove any actual reliance on the defendant's conduct. The district court had dismissed the action based on the admission of plaintiff's agent that he had never seen the financial statements audited by the defendant accounting firm. 516 F.2d at 813. The Second Circuit reversed, however, concluding that the plaintiff was entitled to a presumption of reliance under *Affiliated Ute. Id.* at 814. Rather gratuitously, the court of appeals held that "plaintiff should have the opportunity to prove, *but is not required to prove*, that it saw, or directly relied upon, the financial statements certified by the accounting defendants." *Id.* (emphasis added).

A few months later this type of analysis was adopted by the Ninth Circuit in *Blackie v. Barrack*, 524 F.2d 891, 905-906 (1975), *cert. denied*, 429 U.S. 816 (1976). Before enunciating its more well-known holding that plaintiffs were entitled to a presumption of reliance under the fraud-on-the-market theory, the court held that plaintiffs also were entitled to a presumption of reliance under *Affiliated Ute*. The court noted that the "class members' substantive claims either are, or can be, cast in omission

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cuit, after discussing when reliance may be presumed under *Affiliated Ute*, stated that "appellants concede that they did not read the offering documents and thus did not purchase the bonds in reliance on any material misrepresentations or omissions in those documents. In a traditional Rule 10b-5 case, that concession would be sufficient to justify dismissal." The court also dismissed plaintiffs' claims under a "fraud-created-the-market" theory. *Id.* at 730-731.

or non-disclosure terms—the company's financial reporting failed to disclose the need for reserves, conditions reflecting upon the value of the inventory, or other facts necessary to make the reported figures not misleading." *Id.* Under these circumstances, the court held that plaintiffs were not required to produce positive proof of reliance under *Affiliated Ute. See also Zweig v. Hearst Corp.*, 594 F.2d 1261, 1272 (9th Cir. 1979) (Ely, J., dissenting) (court granted the *Affiliated Ute* presumption despite "affirmative evidence of nonreliance"—plaintiffs had purchased their stock months before the defendant's misleading newspaper column was published). The Tenth Circuit adopted the approach of the Second and Ninth Circuits in *Cronin v. Midwestern Oklahoma Development Authority*, 619 F.2d 856, 859, 861, 862 (10th Cir. 1980) (presumption of reliance proper under *Affiliated Ute* even when plaintiff had not seen defendant's legal opinion and the district court had held that plaintiff did not rely on defendant's conduct).

These holdings, which dispense entirely with any allegation of reliance on the defendant's conduct, could not stand in starker contrast to this Court's holding in *Affiliated Ute.* From a case in which the circumstances overwhelmingly evidenced that plaintiffs had actually and directly relied on defendants in selling their stock, several circuits have managed to find authority for "presuming" reliance in the absence of any reason to believe that plaintiffs relied on *any* conduct of the defendant in making their investment decisions. As discussed next, there is no evidentiary reason for this distortion of the *Affiliated Ute* holding, and it directly conflicts with the intent of Congress when it enacted the express 1934 Act causes of action.

C. Policy Considerations Identified By This Court In Previous Section 10(b) Cases Strongly Support A Requirement That Plaintiffs Prove Some Reliance On A Defendant's Conduct As A Prerequisite To Recovery Of Damages

1. *Unlike Proof Of Reliance On Omissions Of Particular Facts, Proof Of Reliance On A Defendant's Conduct Does Not Impose An Unrealistic Evidentiary Burden On Section 10(b) Plaintiffs*

In *Basic*, 485 U.S. at 245, the Court explained that a presumption of reliance on factual omissions was granted in *Affiliated Ute* to avoid placing an "unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff" to show a speculative state of facts—how the plaintiff would have acted if omitted information had been disclosed. *See also Sharp v. Coopers & Lybrand*, 649 F.2d 175, 188 (3d Cir. 1981), *cert. denied*, 455 U.S. 938 (1982) ("The reason for shifting the burden on the reliance issue has been an assumption that the plaintiff is generally incapable of proving that he relied on a material omission."). Establishing some nexus between the parties by showing reliance on a defendant's conduct, however, does not require plaintiffs to show a speculative state of facts. Rather, plaintiffs can easily demonstrate such reliance if they can allege that they relied on any type of communication from the defendant, whether it be personal, written, audio, video or otherwise, in which the defendant failed to state a material fact. Under these circumstances, it is rational to presume reliance on the factual omission; understanding, of course, that the defendant is permitted to rebut the presumption by adducing affirmative proof of nonreliance. But if there is no communication whatsoever between plaintiffs and defendant, then reliance on defendant's conduct is not likely to be present, and there is no foundation on which to base a presumption that plaintiffs relied on defendant's omission of a particular fact.

For example, the plaintiffs in *Affiliated Ute* demonstrated reliance on defendants' conduct through their

personal contact with the defendants. Indeed, the Court specifically noted that the Indian plaintiffs were compelled to deal with the defendants when they desired to sell their stock. In cases involving alleged omissions in disclosure documents, plaintiffs need only allege that they read and relied on the documents. In this case, reliance on Arthur Young's conduct would not have been difficult to prove, if it had existed. The Class simply could have alleged that its members had heard Arthur Young's oral presentations at the annual meetings or read its audit reports and relied on them in purchasing demand notes. Proof of reliance on a defendant's conduct therefore poses no greater evidentiary problems for Section 10(b) plaintiffs than proof of reliance on affirmative misrepresentations. There is simply no evidentiary reason why an allegation of reliance on at least *some* aspect of a defendant's conduct should not be required in omissions cases.

2. *The Concepts Of Nondisclosure, Materiality, And Duty Are Not Adequate Substitutes For Reliance On A Defendant's Conduct In Defining The Scope Of Liability For Section 10(b) Violations*

Reliance plays a critical role in defining the scope of Section 10(b) liability. In *Basic*, in which the plaintiffs also could not allege that they directly relied on defendant's conduct, the Court required the plaintiffs to allege that they relied on something—an efficient market for their stock—before they were entitled to a presumption of reliance. 485 U.S. at 248 n.27. In the Eighth Circuit's view, however, plaintiffs can avoid having to allege *any* form of reliance simply by pleading the other elements of *Affiliated Ute*—nondisclosure, materiality, and duty. As discussed below, none of these other elements is an adequate substitute for reliance in defining the scope of Section 10(b) liability. Instead, they permit all purchasers or sellers of a given security, including those who purchased or sold for reasons completely unrelated to the defendant's disclosures, to recover their losses in a Section 10(b) action. Consequently, dispensing with proof of

reliance on a defendant's conduct "would effectively convert Rule 10b-5 into 'a scheme of investor's insurance,'" *Basic*, 485 U.S. at 252 (White, J., dissenting) (citation omitted), a result that finds no support in the federal securities laws.

a. *Nondisclosure.* Courts and commentators alike have noted the difficulty in distinguishing between cases involving primarily nondisclosure and cases involving primarily misrepresentation. *See, e.g., Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 93 (2d Cir. 1981); *Sharp v. Coopers & Lybrand*, 649 F.2d at 188; L. Loss, *Fundamentals of Securities Regulation* 1129 (1983) ("although the [*Affiliated Ute*] holding is limited to 'omissions' (nondisclosure) as distinct from 'misrepresentations,' the line between the two is fuzzy") (footnote omitted). The district court addressed this problem in a pre-trial opinion, noting that "every misrepresentation contains within itself the seeds of an omission" and "unless it is watched, the *Affiliated Ute* presumption will swallow all reliance requirements under Rule 10b-5." Pet. App. 215a.

In its post-trial opinion, however, the district court essentially threw up its hands and held that a case involves primarily nondisclosure "so long as any plausible case can be made for the following proposition: that if the plaintiff had known of a given fact, his decision would have been different." Pet. App. 285a-286a. Thus, instead of finding that Arthur Young *misrepresented* the proper carrying value of the Co-op, the district court found that Arthur Young *failed to disclose* the proper carrying value. The court of appeals simply accepted this characterization of the case, noting that "of great relevance in determining this issue is how a claimant pleads its Rule 10b-5 claim." Pet. App. 42a.

If plaintiffs can circumvent the reliance requirement merely by characterizing their cases as involving nondisclosures, little will be left of the requirement. Moreover, even when courts make their own characteriza-

tions, there is little consistency. *Compare Sharp*, 649 F.2d at 189 (in case involving both misrepresentations and omissions, court granted an *Affiliated Ute* presumption because defendant's "misrepresentation of other facts should not alleviate its burden of proving nonreliance") *with Wilson*, 648 F.2d at 93 (*Affiliated Ute* presumption available only when "no positive statements exist" and "reliance as a practical matter is impossible to prove"). In sum, the pliability of the concept of nondisclosure has made it an ineffective check on unwarranted expansion of the *Affiliated Ute* presumption.

b. *Materiality*. Materiality also is not an adequate substitute for reliance on a defendant's conduct. Rather, materiality is a much broader concept that produces a correspondingly much broader base of liability than reliance. Determining materiality—what information a reasonable investor would consider important in making an investment decision—is a theoretical exercise that is sure to encompass a great deal of information that would not necessarily induce an actual investment decision by any particular person. For example, even a document containing an omission of a material fact may also contain such negative information about a company that many potential purchasers would be dissuaded from investing. Proof that a plaintiff actually was aware of the defendant's disclosures and still purchased or sold, however, provides a concrete, factual link between defendant's conduct and plaintiff's decision to purchase or sell a security, and it thereby provides a much stronger basis on which to hold the defendant responsible for any loss that the plaintiff may have realized on the investment.

This case provides a clear example of the importance of reliance on a defendant's conduct in establishing a basis for liability. In view of the negative information that was disclosed concerning the Co-op's financial condition at the annual meetings, it may well be that no person who actually attended an annual meeting and heard Arthur Young's oral presentations subsequently purchased a demand note. For example, those who attended the

annual meeting in 1982 would have learned that the Co-op had acquired the gasohol plant, that it had lost $1.2 million the previous year, and that the Co-op had never previously lost more than $138,000 in a single year. Pet. App. 17a; C.A. Jt. App. 231. The atmosphere at the meeting became very heated when this information was revealed. Those who attended the annual meeting in 1983 would have learned that the Co-op lost another $1.2 million in 1982 and that its current liabilities were more than double its current assets. C.A. Jt. App. 261-263. It seems extremely unlikely that many attendees of the annual meetings would have considered the Co-op an attractive business in which to become a short-term creditor.

The point of this discussion of disclosures at the annual meetings is not to persuade that they were not misleading or to absolve Arthur Young from liability if any class members actually had been shown to have attended the meetings. Rather, the purpose is to illustrate that dispensing with proof of any affirmative reliance on the defendant's conduct can cause perverse results—plaintiffs can recover their investment losses from a defendant even though the losses likely would have been avoided if the plaintiffs in fact had relied on the defendant's conduct. This is exactly the type of investors' insurance that Congress did not intend to create when it enacted the 1934 Act.

c. *Duty*. Finally, duty, like nondisclosure and materiality, is not an adequate substitute for reliance in defining the scope of liability for Section 10(b) violations. Many securities markets participants, such as issuers and their officers and directors, owe duties to investors that are legally well established. Consequently, reliance could be "presumed" as to some defendants in nearly all Section 10(b) cases. Moreover, as evidenced by the Eighth Circuit's adoption of a "flexible duty" test in this case, the courts often are not shy about finding a "duty" in a wide variety of circumstances.[10]

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[10] The flexible duty test was applied by the Ninth Circuit in *Zweig v. Hearst Corp.*, 594 F.2d 1261, 1268-1269 (9th Cir. 1979),

Ironically, one of the seven factors that the court of appeals believed was most important in finding that Arthur Young owed a duty to the Class was awareness that demand note purchasers relied on Arthur Young in making their investment decisions. Pet. App. 46a. Consequently, in response to Arthur Young's argument that the record did not indicate that even one demand note purchaser had ever relied on anything Arthur Young said or did, the court of appeals granted a presumption of reliance in part because Arthur Young should have been aware that such purchasers were relying on it. The court of appeals thereby recognized the theoretical importance of reliance, but apparently believed that *theoretical* reliance was more important than *factual* reliance in defining the scope of Section 10(b) liability.

For present purposes, Arthur Young does not contest that those who read its audit reports or heard its oral presentations were entitled to a presumption of reliance, and it would not be petitioning this Court if the lower courts had imposed liability on this basis. No evidence, however, has been presented to indicate that any Class member cared about Arthur Young's opinion on the Co-op's financial condition prior to this lawsuit. Arthur Young submits that plaintiffs who were uninterested in what a defendant *did* say about a company before they decided to invest should not be entitled to a presumption of reliance on what the defendant did *not* say after they file an action under Section 10(b).

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to hold that the defendant newspaper columnist owed the requisite duty for an *Affiliated Ute* presumption to his readers, as well as the plaintiffs—two non-readers who had purchased their stock months before the defendant's column was published.

II. THE COURT OF APPEALS DISREGARDED ACCEPTED RULES OF APPELLATE PROCEDURE WHEN IT ADOPTED A THEORY OF LIABILITY UNDER THE ARKANSAS SECURITIES ACT THAT WAS NECESSARILY BASED ON FACTUAL FINDINGS NOT MADE BY THE DISTRICT COURT, NOT PRESENTED TO THE JURY, AND NOT OTHERWISE SUPPORTED BY THE RECORD

It is a general rule of appellate procedure that a federal appellate court does not consider factual issues that were not passed upon in lower court proceedings. *Singleton v. Wulff*, 428 U.S. 106, 120-21 (1976). As the Court has noted, this rule is "essential in order that parties may have the opportunity to offer all the evidence they believe relevant to the issues which the trial tribunal is alone competent to decide; it is equally essential in order that litigants may not be surprised on appeal by final decision there of issues upon which they have had no opportunity to introduce evidence." *Hormel v. Helvering*, 312 U.S. 552, 556 (1941); *see also SEC v. Chenery Corp.*, 318 U.S. 80, 88 (1943) ("where the correctness of the lower court's decision depends upon a determination of the fact which only a jury could make but which has not been made, the appellate court cannot take the place of a jury").

In this case, the court of appeals rejected the district court's common law theories for holding Arthur Young liable under the Arkansas Securities Act ("Act"), but nevertheless affirmed the district court's judgment by adopting a theory of aiding and abetting liability that necessarily was based on factual issues not passed upon by the district court, not presented to the jury, and not otherwise supported by the record. Arthur Young therefore was quite "surprised"—and unfairly so—by the Eighth Circuit's decision. While this Court has recognized exceptions to the general appellate rule where "the proper resolution is beyond any doubt," or where "injustice might otherwise result," *Singleton*, 428 U.S. at 121 (citations omitted), these exceptions are not applicable in this case.

The relevant provisions of the Act, which were derived from Section 410 of the Uniform Securities Act, 7B U.L.A. 643 (1956) (superseded 1985), impose primary liability on sellers of securities for sales made by means of misleading disclosures. Ark. Stat. Ann. § 23-42-106(a)(1)(B). In addition, the Act imposes two types of secondary liability on specifically enumerated classes of persons. Ark. Stat. Ann. § 23-42-106(c). Control person liability is based solely on a person's "status" as a partner, officer, or director of a seller, a person performing a similar function, or any other person who controls a seller. Aiding and abetting liability is imposed only on an "employee" of the seller, "broker-dealer," or "agent" who materially aids in a sale that violates the Act.[11]

The district court repeatedly indicated that Arthur Young did not fall within any of the statutorily enumerated categories of persons having secondary liability, but decided that statutory liability could be implicated under the Act against all those who would be liable as joint tortfeasors at common law. *See, e.g.*, Pet. App. 268a ("surely there can be no impediment in the language of the statute to an implication of liability against one not named as liable by the Act"); Pet. App. 211a (statutory enumeration of parties with secondary liability not "meant to supplant the common law, by exculpating those parties who otherwise would be liable as joint tortfeasors"). The court of appeals properly rejected the district court's attempt to rewrite the statute, but found that Arthur Young was still liable under the Act because "the jury could have held Arthur Young liable only if it concluded that the firm materially aided in the sale of demand notes." Pet. App. 37a.

This conclusion alone, however, was not sufficient to impose aiding and abetting liability on Arthur Young, be-

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[11] The Arkansas statute should be contrasted with other state securities statutes derived from the Uniform Securities Act that have been amended specifically to impose secondary liability on *any* person who materially aids in a sale. *See, e.g.*, Okla. Stat. Ann. tit. 71, § 408(b) (West Supp. 1992); Or. Rev. Stat. § 59.115(3) (1989).

cause such liability is imposed only on "employees," "broker-dealers" and "agents"—a critical statutory requirement that has been emphasized by the Supreme Court of Arkansas. *See Hogg v. Jerry*, 773 S.W.2d 84, 89 (Ark. 1989) ("appellees argue that [defendant] materially aided in the sale of each investment, yet [defendant] meets neither the statutory definition of an employee, an agent, or a broker-dealer"). The district court did not find that Arthur Young fell within any of these statutory categories. Indeed, it was for this very reason that the district court engrafted common law theories of joint tortfeasor liability onto the Act. Consequently, the issue of whether Arthur Young was an "employee," "broker-dealer," or "agent" was not presented to the jury.

The court of appeals did not make an explicit finding, but the only conceivable category in which Arthur Young might fall is that of an employee of the Co-op.[12] "Employee" is not defined in the Act, but the governing test under Arkansas common law is "whether the asserted employer had the right to control" the alleged employee in its work. *Sandy v. Salter*, 541 S.W.2d 929, 931 (Ark. 1976); *see also Martin v. Pepsi-Cola Bottling Co.*, 639 F. Supp. 931, 935 (D. Md. 1986) (independent contractor not an employee under Maryland version of

[12] Arthur Young does not even arguably fall within the other two categories. "Broker-dealer" is statutorily defined as "any person engaged in the business of effecting transactions in securities for the account of others or for his own account." Ark. Stat. Ann. § 23-42-102(3). "Agent" is statutorily defined as an individual "who represents a broker-dealer or issuer in effecting or attempting to effect purchases or sales of securities." Ark. Stat. Ann. § 23-42-102(2). This category therefore is more aptly labeled as "selling agent," and, like broker-dealers, selling agents must register with the Arkansas Securities Commissioner. *See Jenson v. Touche Ross & Co.*, 335 N.W.2d 720, 729 (Minn. 1983) (under Minnesota version of Uniform Securities Act, auditor could not be considered statutory agent of seller). Arthur Young neither falls within either of these categories nor ever had reason to litigate the factual issues necessary to a finding that it fell within either of these categories.

Uniform Securities Act); *Allen v. Columbia Financial Management*, 377 S.E.2d 352, 356 (S.C. Ct. App. 1988) (under South Carolina version of Uniform Securities Act, attorney was held not to be an employee of the seller).

Arthur Young clearly was not under the control of the Co-op. Indeed, the Class alleged just the opposite state of affairs in the proceedings below—that Arthur Young controlled the financial reporting of the Co-op and therefore either controlled the Co-op or performed a function similar to that of chief financial officer of the Co-op. *See, e.g.*, Appellees' Supplemental Brief on Remand at 12-13. Even these factual allegations were rejected by the court of appeals in the context of evaluating the Class' RICO claims. The court found that Arthur Young's involvement with the Co-op "in no way rise[s] to the level of participation in the management or operation of the Co-op." Pet. App. 30a. In sum, the court of appeals' theory of liability necessarily was based on factual findings not made by the district court, not presented to the jury, and not otherwise supported by the record.

We recognize that the Court generally does not grant certiorari to decide state law issues,[13] and the determination of whether an issue should be considered on appeal is left primarily to the discretion of the courts of appeals. *Singleton*, 428 U.S. at 121. Nevertheless, the court of appeals' action in this case sufficiently departed from accepted rules of appellate procedure that it im-

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[13] Because the relevant provisions of the Act were derived from the Uniform Securities Act, which has been adopted in 33 states, 7B U.L.A. 124 (1991 Supp.), the Eighth Circuit's interpretation of an auditor's aiding and abetting liability could have broader ramifications than would normally be the case. State securities law issues tend to be litigated quite frequently in federal courts because claims under state securities laws are often brought in conjunction with claims under the federal securities laws. Our review of the annotations to the Uniform Securities Act has not revealed any other case in which an auditor was found to have aiding and abetting liability as an employee, broker-dealer, or agent.

plicates the supervisory responsibility of this Court to ensure that the courts of appeals properly perform their judicial function. Because of the peculiar nature of the issue presented by this case, liability has been imposed on Arthur Young based on a legal theory that Arthur Young has not had reason to contest in *any* forum. Consequently, the Court should grant this petition in order to reverse the Eighth Circuit's judgment because it was based on a legal theory not supported by the record after a month-long jury trial. Alternatively, the Court could remand for further proceedings necessary to resolve the factual issues underlying the Eighth Circuit's theory of liability.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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In The

Supreme Court of the United States

October Term, 1991

ERNST & YOUNG,

Petitioner,

v.

BOB REVES, ET AL.,

Respondents.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

VOLUME I

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APPENDIX A

United States Court of Appeals

FOR THE EIGHTH CIRCUIT

No. 87-1726WA

Arthur Young & Co.,	*	Appeals and
Appellant,	*	Cross-Appeal
	*	from the
v.	*	United States
Bob Reves; Robert H. Gibbs;	*	District Court
& Frances Graham,	*	for the
	*	Western District
Appellees.	*	of Arkansas
	*	

No. 87-1727WA

Thomas E. Robertson, Jr., *
As Trustee of the Farmer's *
Co-op of Arkansas and Oklahoma,*
Inc., and as representative *
of a class of members, depositors, *
and equity security holders, who *
are similarly situated to him; *
Bob Reves; Frances Graham; Robert *
H. Gibbs, individually; Robert H. *
Gibbs, as natural guardian of his *
minor children, Thomas A. Gibbs *
and Robert H. Gibbs, Jr.; and *

Robert H. Gibbs, as Trustee of *
the Muskogee Internal Medicine *
Group Profit Sharing Funds, *
*
Appellants, *

v. *
*
Arthur Young & Co., *
*
Appellee. *
*

No. 87-1803WA

Thomas E. Robertson, Jr., As *
Trustee of the Farmer's Co-op *
of Arkansas and Oklahoma, Inc., *
and as representative of a *
class of members, depositors, *
and equity security holders, *
who are similarly situated to *
him, *
*
Appellees, *
*
v. *
*
Arthur Young & Co., *
*
Appellant. *

No. 87-2533WA

Thomas E. Robertson, Jr., etc., *
et al. vs. Jack White, et al. *

Thomas E. Robertson, Jr., As *
Trustee of the Farmer's Co-op *
of Arkansas and Oklahoma, Inc., *
and as representative of a *
class of members, depositors, *
and equity security holders, *
who are similarly situated to *
him; Bob Reves; Frances Graham; *
Robert H. Gibbs, individually; *
Robert H. Gibbs, as natural *
guardian of his minor children, *
Thomas A. Gibbs and Robert H. *
Gibbs, Jr.; and Robert H. *
Gibbs, as Trustee of the *
Muskogee Internal Medicine *
Group Profit Sharing Funds, *
*
Appellees, *

v. *
*
Arthur Young & Co., *

Appellant. *

No. 88-1014WA

Thomas E. Robertson, Jr., etc., *
et al. vs. Jack White, et al. *
*
Robert R. Cloar, Class Counsel, *

Appellant, *
*
v. *

Bob Reves, *
*
Appellee. *

Submitted: March 12, 1991

Filed: June 27, 1991

Before FAGG, Circuit Judge, SNEED,* Senior Circuit Judge, and MAGILL, Circuit Judge.

MAGILL, Circuit Judge.

* THE HONORABLE JOSEPH T. SNEED, Senior Judge, United States Court of Appeals for the Ninth Circuit, sitting by designation.

Arthur Young appeals from the district court's entry of judgment against it after a jury found that the firm had violated both federal and state securities laws.[1] On

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[1] This appeal is before us on remand after the Supreme Court reversed our earlier decision that the financial instruments at issue in this case were not federal securities. *See Reves v. Ernst & Young*, 110 S. Ct. 945 (1990), *rev'g Arthur Young & Co. v. Reves*, 856 F.2d 52 (8th Cir. 1990). We had ruled that the instruments were not federal securities under the test from *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946). *See* 856 F.2d at 55. The Supreme Court, however, declined to apply the *Howey* test,

(Continued on following page)

appeal, Arthur Young argues that the district court erred in (1) certifying the plaintiff class; (2) holding that the financial instruments at issue in this case were securities under Arkansas law; (3) denying its motion for judgment notwithstanding the verdict on the state and federal securities claims; and (4) denying its motion for a new trial on the ground that a requested instruction on contribution was not given to the jury. Arthur Young also argues that the damages awarded to the appellees were not supported by the evidence and challenges the district court's awards of attorney fees, costs, and interest to the appellees. On cross-appeal, Reves and Robertson challenge a number of the district court's rulings, including its dismissal of Robertson's breach of contract claim, its granting of summary judgment in favor of Arthur Young on Reves, RICO claim, its crediting of settlement proceeds against the jury's verdict, and its decision on fees for Reves' counsel. We affirm in part and reverse in part.

I.

A. The Co-op

The facts of this case involve the Farmer's Cooperative of Arkansas and Oklahoma, Inc. (Co-op), which was organized in 1946 and operated in western Arkansas and eastern Oklahoma. Any farmer in the area could become

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(Continued from previous page)

and instead applied the Second Circuit's "family resemblance" test, *see, e.g., Exchange Nat'l Bank v. Touche Ross & Co.*, 544 F.2d 1126 (2d Cir. 1976), to conclude that the instruments were securities under federal law. 110 S. Ct. at 952.

a member, and as a member was entitled to one share and one vote. Each year the Co-op's members elected twelve of their own to serve on a Board of Directors. The Board met monthly to review the Co-op's operations, but delegated actual management of the Co-op to a general manager, whom the Board appointed. In 1952, the Board named Jack White as general manager. White served in that capacity until the Board removed him in mid-1982.

To raise money for its operating expenses, the Co-op sold promissory notes payable to the holder on demand. These demand notes, while uncollateralized and uninsured, were nonetheless attractive to investors because they paid a higher interest rate than that local financial institutions offered. The Co-op advertised the demand note program in its monthly newsletter as an "Investment Program." The advertisement stated the rate of interest the notes would earn and claimed: "YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments. The Investment is not Federal [sic] Insured but it is . . . Safe . . . Secure . . . and available when you need it. Interest is computed to the day of withdrawal." *See, e.g.*, Joint Appendix (JA) at 1820 (ellipses in original).

B. The Gasohol Plant

In 1979, the Co-op's general manager, White, joined with entrepreneur Edwin Dooley to finance and construct a gasohol plant. Dooley and White each invested $125,000 of their own funds and as a result each owned half of the enterprise, which was known as Big D & W Refining and Solvents, Inc. Dooley served as president of the corporation; White was its secretary. Construction of the plant

began in June 1979. Four months later, White, financed by a loan from the Citizens Bank & Trust Company (Citizens Bank), purchased Dooley's interest in Big D & W and renamed the company White Flame Fuels, Inc. (White Flame).

Beginning in January 1980, White obtained loans from the Co-op to finance the continued construction and the initial operation of the gasohol plant. White personally guaranteed these loans. The plant finally began producing gasohol the following April, but was soon beset by problems stemming from the plant's poor design and outside economic factors. White continued to obtain loans from the Co-op; by December 1980, these loans totalled approximately $4 million.

In September 1980, White was indicted for federal tax fraud. The indictment charged, among other things, that White had engaged in a course of self-dealing with the Co-op and had filed fraudulent tax returns. Also indicted with White was Gene Kuykendall, the Co-op's longtime accountant, who was also White Flame's accountant at this time.

Shortly after the indictment, at a November 12, 1980, Board meeting, White proposed that the Co-op purchase White Flame. The Board agreed and voted to acquire the company. One month later, however, the Co-op filed a declaratory action against White and White Flame in state court. The complaint had been drafted by White's attorneys, and alleged that on February 15, 1980, White had told the Board that all of White Flame's stock would be transferred to the Co-op in exchange for the Co-op's assumption of White's debts to the Co-op and Citizens

Bank.[2] The complaint alleged that in reliance on this agreement, the Co-op invested further sums in White Flame, based on the assumption that it owned the company. The complaint next alleged that White did not transfer the stock as agreed, and that the Co-op had not executed a note assuming White's debts to Citizens Bank. Based on these allegations, the Co-op sought a declaratory judgment stating that the Co-op had acquired White Flame on or about February 15, 1980; that the Co-op had assumed Jack White's debt to Citizen's Bank; that all amounts the Co-op lent to Jack White or White Flame before February 15, 1980, were investments in White Flame; and that Jack White was discharged from any debts to the Co-op relating to White Flame.

Shortly after the complaint was filed, White's attorneys sent the Co-op's attorney, Carl Creekmore, White's answer and a proposed consent decree. Creekmore filed the answer and obtained the state court's approval of the decree on December 19; but the decree was not filed until January 26, 1981. The decree provided that the Co-op had owned White Flame since February 15, 1980; that the Co-op had assumed White's debt to Citizen's Bank; and that White was discharged from any liability to the Co-op for loans for White Flame. The result of this friendly suit was that White was relieved of over $4 million of debt and that the Co-op owned White Flame as of February 15, 1980.

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[2] The minutes of the Co-op Board Meeting for February 15, 1980, do not contain any references to the Co-op acquiring the stock of White Flame. JA at 933. In fact, the first reference to the Co-op purchasing White Flame does not occur until the minutes of the November 12, 1980, Board meeting. JA at 1070.

C. The 1981 Audit

Both White and Kuykendall were convicted of tax fraud in January 1981.[3] Testifying on White's behalf at the criminal trial was Harry Erwin, the managing partner of Russell Brown and Company, Arkansas' largest accounting firm at that time.[4] Shortly after White's conviction, his lawyer contacted a member of Russell Brown and stated that the Co-op was interested in hiring the firm. In June 1981, Jack White and Kirit Goradia, the Co-op's office manager, met with Erwin and Joe Drozal, another member of Russell Brown. Later that year the Co-op hired Russell Brown to perform the Co-op's 1981 audit. Joe Drozal was named the partner in charge; Joe Cabaniss was selected to assist him.

After beginning the 1981 audit process in early 1982, Drozal became aware that there were problems concerning how White Flame should be treated for accounting

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[3] This court affirmed these convictions in *United States v. White*, 671 F.2d 1126 (8th Cir. 1982). The evidence in the criminal case showed that White had engaged in a course of self-dealing with the Co-op, and that he and Kuykendall had cooked the Co-op books and filed fraudulent tax returns to cover up White's activities. We concluded: "The record clearly demonstrates that White and Kuykendall manipulated the Co-op's finances to serve their own personal ends, and that they distorted the Co-op's records of receipts. . . . " *Id.* at 1134.

[4] On January 2, 1982, Russell Brown merged with Arthur Young and Company. After the merger, Erwin was placed in charge of Arthur Young's Arkansas practice. Later, Arthur Young and Company became Ernst & Young. For the sake of consistency with the earlier opinions in this case, future references will be to "Arthur Young."

purposes. In a January 26, 1982,[5] memo, Drozal raised several problems relating to the valuation and acquisition of White Flame. He observed that White Flame's records contained no detailed documentation of cost or expense allocations. Drozal also specifically noted that the Co-op's audited financial statement for 1980 had disclosed the Co-op's full ownership of White Flame, but had not disclosed that the Co-op had forgiven the $4 million in loans White had personally guaranteed. JA at 1189-91.

One of Drozal's first tasks in the audit was to determine White Flame's fixed asset value. Drozal realized that he could not rely on the fixed asset value provided for White Flame in the 1980 financial statement because Kuykendall, a convicted felon, had prepared that statement. Therefore, Drozal had to determine it on his own. One way of determining fixed asset value is to add the asset's construction costs to its capitalized expenses. Drozal knew there was a problem with White Flame's reported capitalized expenses, because Jack White had told him that because the plant was only producing at 20% of capacity, they had included only 20% of their production costs as expenses; the remaining 80% of the production costs were added to the fixed asset value of the plant. Drozal's superior at Arthur Young informed him that only those costs reasonably associated with construction should be added to the plant's value. JA at 1215; 9 Tr. at 236. Drozal's investigation into the treatment of the production costs was limited mainly to talking with Jack White, and reviewing the construction costs and

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[5] Russell Brown had merged with Arthur Young by this time. *See supra* note 4.

capitalized expenses reported in White Flame's books, which Drozal knew that Kuykendall had prepared. 9 Tr. at 186.[6] Drozal concluded, based primarily on information provided by convicted felons, that the plant's value at the end of 1980 was $4,393,242.66, exactly the same figure Kuykendall had calculated. JA at 1219. Using this figure as a base, Drozal factored in the 1981 construction costs and capitalized expenses, and concluded that White Flame's 1981 fixed asset value was approximately $4.5 million. *Id.*

Once Drozal determined White Flame's fixed asset value, he had to determine how that value should be treated for accounting purposes. This involved examining the circumstances of the Co-op's acquisition of White Flame. If the Co-op had owned White Flame from the beginning of construction in 1979, White Flame's value for accounting purposes would be its fixed asset value, $4.5 million. If the Co-op had purchased White Flame from Jack White, however, then White Flame's value for accounting purposes would be its fair market value at the time of purchase. Moreover, if the Co-op had purchased White Flame from White, the transaction would have to be closely scrutinized, because White was an officer of the Co-op. Drozal concluded that the Co-op had owned White Flame from the beginning, and thus that the plant should be valued at $4.5 million. He based this conclusion on the Co-op's having lent White funds for the

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[6] Kuykendall testified that he fabricated these numbers on White's direction and attempted to cover up the scheme by slightly varying the percentages of costs expensed. 7 Tr. at 258.

plant's construction and operation; that White was supervising the construction and operation; and that the court decree stated that all of the Co-op's loans to White had been investments in the plant. 9 Tr. at 224. Drozal believed that characterizing White Flame as having always been owned by the Co-op reflected "economic reality." *Id.*

In concluding that the Co-op had always owned White Flame, Drozal ignored a great deal of information suggesting exactly the opposite. For example, although he relied on the court decree's statement that the Co-op's loans to White were really investments, Drozal ignored that part of the decree that stated that the Co-op had acquired White Flame on February 15, 1980. He ignored the facts that White Flame's tax returns indicated that it was owned by Jack White and Edwin Dooley; that each had initially invested $125,000 in White Flame; that White had eventually bought Dooley out; that White had always personally guaranteed the loans he received from the Co-op; and that the Co-op's 1979 audit contained no mention of White Flame. Drozal never talked with Dooley, with any 1979 or 1980 Board members, with the Co-op's lawyer, or with the Co-op's previous auditor.

By concluding that the Co-op had always owned White Flame, Drozal was able to avoid applying auditing standards that required a closer look at the actual acquisition and was also able to avoid having to value the plant at its fair market value. The advantage of reaching this conclusion was clear: Drozal knew that if White Flame were valued at less than $1.5 million, the Co-op's net

worth for 1981 would have been wiped out. 10 Tr. at 41.[7] Drozal also knew that bad news about the Co-op's financial condition could provoke a run on the demand notes and thus deprive the Co-op of its primary source of funds. 9 Tr. at 189.

D. The 1981 Audit Report to the Board

On April 22, 1982, Arthur Young[8] presented its 1981 audit report to the Co-op's Board of Directors. Arthur Young concluded that with two exceptions, the Co-op's consolidated financial statements fairly presented the Co-op's financial position. The relevant exception stated that Arthur Young had "some doubt as to the recoverability of the investment in the gasohol plant of White Flame Fuels, Inc. and its continuing operations." JA at 235. The firm explained: "Management has not prepared projections and other analyses to assess the potential recovery of this investment. Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated financial statements." *Id.*

The financial statements attached to the audit report listed the Co-op's assets at $20,869,300. Included in this

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[7] One expert witness testified at trial that as of December 31, 1981, White Flame was not economically viable, and that its liquidation value was $500,000 to $700,000. 4 Tr. at 97. Another expert, who used a more sophisticated appraisal method, testified that White Flame's fair market value at the end of 1981 was between $444,000 and $1.5 million. 4 Tr. at 184. Arthur Young did not attempt to rebut this testimony.

[8] *See supra* note 4.

total was $4,522,086 for the gasohol plant. The Co-op's liabilities totaled $18,246,743, including $12,164,007 in unredeemed patron demand notes. The Co-op's net worth was $2,622,557. The financial statement's Note 9 addressed White Flame. The note stated, in relevant part:

> Financing of the initial construction and subsequent revisions which totaled approximately $4,522,000, was provided by the Co-op. Also, from the initial start of production through December 31, 1981, the Co-op has provided operating capital for White Flame. As of December 31, 1981, the Co-op had an investment of approximately $5,830,000 in White Flame. The ability of the Co-op to continue providing funds to cover the operating losses of White Flame Fuels, Inc. (currently averaging $100,000 per month) until such time that improvements in market conditions and production efficiency permit profitable operations are not determinable. The combination of factors as mentioned above, which must result favorably, cast doubt on the recovery by the Co-op of its investment in White Flame Fuels, Inc. and the recovery by White Flame Fuels, Inc. of its investment in plant and equipment on the basis of a going concern. Projections and other analyses have not been prepared by management in order to assess the potential recoverability of this investment.

JA at 251-52.

Arthur Young did not tell the Board that it concluded that the Co-op had always owned White Flame and thus was able to value the plant at $4.5 million. 9 Tr. at 227. Nor did it tell the Board that if the Co-op had purchased

White Flame, as opposed to owning it from the beginning, there might be a net worth problem. Moreover, Arthur Young never specifically asked the Board or the Co-op's management for projections as to the operations of White Flame. 10 Tr. at 57-58.

E. The 1982 Annual Meeting

On May 27, 1982, the Co-op held annual meeting. Approximately 350 people attended. At the meeting, the Co-op distributed condensed financial statements that purported to convey the economic health of the organization.[9] The condensed financial statement for 1981 stated that the Co-op's assets were $20,869,300 and that its liabilities were $18,246,743, leaving the Co-op with a net worth of $2,622,557. JA at 1231. The statement included White Flame's $4.5 million asset value in its total assets, but did not include White Flame's $1.2 million loss. The statement also failed to include any of the information about White Flame's status found in Note 9 of the audit report.

The condensed financial statement also contained the annual meeting's agenda. Listed as giving the financial report was "Harry C. Erwin, C.P.A., ARTHUR YOUNG & COMPANY." JA at 1241. Also present from Arthur Young was Joe Cabaniss. Erwin received the two condensed

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[9] The Co-op prepared these statements based on Arthur Young's audit report and the accompanying financial statement.

financial statements when he arrived at the meeting. He had no advance preparation as to the statement's contents. As he began his presentation, Erwin informed the members that they had condensed statements and that copies of the full audit were at the Co-op's offices. Erwin then started to discuss the condensed statement. The audience soon began asking questions about the acquisition of White Flame and its financial status. When asked how much money White Flame had lost, Erwin responded that it was a separate corporation under federal law. Erwin was also asked how the Co-op had acquired White Flame and responded that he thought the Board had voted to acquire it. During these interchanges, White Flame's $1.2 million loss was disclosed to the audience. The meeting began to get very heated, with the audience asking many questions about White Flame and other items in the condensed statement. As the questions increased in both frequency and intensity, Erwin was unable to respond and the Board moved the meeting on.

The result of Erwin's five-minute presentation was that the audience knew that the Co-op owned White Flame and that the plant had $1.2 million in losses. However, Erwin did not disclose the following: Arthur Young's conclusion that the Co-op had always owned White Flame; that as a result of this conclusion White Flame was valued at $4.5 million; the material in Note 9 of the full financial statement; that Arthur Young had qualified its audit opinion; that Arthur Young could not satisfy itself as to the proper carrying value of White Flame; or that a write-down of White Flame to its fair market value would wipe out the Co-op's net worth. 12 Tr. at 112-13.

F. The 1982 Audit

The Co-op also hired Arthur Young to perform the 1982 audit. Erwin and Drozal were again Arthur Young's point men. Joe Cabaniss was again selected to work with Drozal and prepared a background memo on the 1982 audit. JA at 1234. The memo classified the Co-op as a "close monitoring client," i.e., a client that might pose some type of risk to Arthur Young. The memo also addressed issues of particular importance for the Co-op's audit. These included the recoverability of the gasohol plant and the condensed financial statements for 1981. As regards the gasohol plant, Cabaniss, before talking to Drozal, believed its acquisition involved a related party transaction, and hence that the Co-op had not always owned it. Cabaniss also expressed his doubts as to whether the gasohol plant could ever make money. As regards the condensed financial statements, Cabaniss noted:

> At the annual meeting the patrons are provided with condensed financial statements. Last year they were given a consolidated balance sheet and a Co-op only income statement which did not reflect the equity in the earnings (loss) of White Flame. We should advise the client of this misleading presentation and find an acceptable manner of presentation.

JA at 1240.

Arthur Young proceeded with the audit. Standard auditing procedures require the auditor to obtain a client representation letter. This letter, drafted by the auditor, but signed by the client's chief executive and financial

officers, states that the client's financial records are accurate and consistent with generally accepted accounting principles. The Co-op's letter for the 1982 audit was signed by Fred Howard, who had replaced Jack White as the Co-op's General Manager. Kirit Goradia, the Co-op's office manager, who essentially functioned as its chief financial officer, did not sign the letter. In the space provided for signing one's name, Goradia wrote: "My only response is attached herewith not as part of this letter." JA at 1245. The attachment stated: "This is to state that during the course of your 1982 audit of books and records of [the Co-op and White Flame], I have not intentionally withheld any information from you." JA at 1246. Goradia told Cabaniss that he did not want to sign the letter because if something happened later, he did not want to be accused of wrongdoing. 11 Tr. at 140. Normally, when a company's chief financial officer refuses to sign a representation letter, the auditor is supposed to disclaim the audit opinion or issue an adverse opinion. Id. at 142. Arthur Young, however, did not believe that Goradia had refused to sign the letter, and thus did neither.[10]

G. The 1982 Audit Report to the Board

Arthur Young presented its 1982 audit report to the Board on March 7, 1983. The 1982 report was substantially similar to the 1981 report. Arthur Young again

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[10] Arthur Young did not get a signed client representation letter for the 1981 Co-op audit either. When asked about this at trial, Cabaniss responded: "Now, the year before, we thought we had that sucker, and . . . we believed we had it. There was no reason to even think it had been refused." 11 Tr. at 142.

stated that "there is some doubt as to the recovery of the investment in [White Flame] and its continuing operation. Management has not prepared projections and other analyses to assess the potential recovery of this investment." JA at 258. Arthur Young again concluded: "Accordingly, we are unable to satisfy ourselves as to the appropriate carrying value of such amounts as presented in the accompanying consolidated financial statement." *Id.* Arthur Young's concerns were more fully explained in Note 8 to the financial statement, which was basically the same as the 1981 audit report's Note 9.

The 1982 financial statement reported that the Co-op had assets of $17,127,986 and liabilities of $15,741,240, resulting in a net worth of $1,386,746. The gasohol plant was listed as an asset worth $4,537,520.

H. The 1983 Annual Meeting

The Co-op's 1983 annual meeting was held on March 24 of that year. Sometime before the meeting Goradia and Cabaniss discussed the Co-op's condensed financial statements. Cabaniss told him that Arthur Young's name should not be on the condensed statement because the statement would be misleading without the explanatory notes. Shortly before the meeting Cabaniss and Drozal received a copy of the condensed statement, which stated in boldface letters across the top of the page: "The following financial information was condensed from Arthur Young & Company's Annual Audit." JA at 1248. Drozal and Cabaniss saw that Arthur Young's name was on the statement and that Note 8 was omitted, but said nothing to Goradia. 11 Tr. at 149.

The annual meeting's program stated that the financial report would be given by Arthur Young. Cabaniss began the financial report by informing the audience that they possessed condensed statements, and that full audit reports were at the Co-op's offices. He knew as he began that the condensed statement was misleading because it did not contain the explanatory notes to the audit. Id. at 150. The presentation lasted three minutes. Cabaniss did not tell the audience that the report was misleading. He did not tell them about Note 8, that Arthur Young was unable to satisfy itself as to White Flame's value, or that if White Flame was written down to its fair market value the Co-op might be in financial trouble. At that time, White Flame's stated value after depreciation was approximately $3.5 million. The Co-op's net worth was $1.3 million. If the plant had been written down to less than $2.2 million, the Co-op's net worth would have been wiped out.[11]

I. Bankruptcy

The demand note program was not the Co-op's only source of funds. It also received loans and lines of credit from the Cooperative Finance Association (CFA), which was owned by Farmland, a regional supply cooperative. William Moon, a vice-president of CFA, had informed the Co-op that because of its reliance on demand notes, if the amount of invested notes dropped below $9.5 million, CFA would cut off the Co-op's line of credit. In the fall of

[11] *See supra* note 5 for the experts, appraisals of White Flame's value.

1983, CFA advanced the Co-op a $5.78 million line of credit to finance its grain inventory and operations. 3 Tr. at 46. In February of 1984, representatives of the Co-op met with CFA to arrange more financing. 12 Tr. at 12. Later that month the Co-op had a slight run on the demand notes. Id. The Co-op asked CFA for the money on its line of credit to protect itself from further runs. *Id.* CFA, because total demand note investments had dropped below $9.5 million, decided not to advance the Co-op any of the $800,000 the Co-op had remaining on its line of credit. 3 Tr. at 161. The Co-op then filed bankruptcy proceedings on February 23, 1984, to protect itself from a run on the demand notes. 12 Tr. at 13. In the subsequent bankruptcy disclosure statement, which the bankruptcy court approved on September 4, 1984, the Co-op asserted that three factors caused its bankruptcy: (1) ineffective management; (2) using demand notes as the primary source of financing; and (3) the financial problems of White Flame. AY Ex. 223. The result of the bankruptcy filing was that the demand notes were frozen in the bankruptcy estate, and thus were no longer redeemable at will by the noteholders.

J. Trial

After the Co-op filed for bankruptcy, it remained as debtor in possession until October of that year, when the bankruptcy court appointed Thomas Robertson as trustee. On February 14, 1985, Robertson, on behalf of the Co-op and certain demand noteholders, filed suit against forty individuals and entities, including members of the Co-op's Board, the Co-op's lawyers, Jack White, Kirit

Goradia, Gene Kuykendall, and Arthur Young. On September 27, 1985, the district court certified a class of noteholders consisting of people who purchased demand notes between February 15, 1980, and February 23, 1984, naming Bob Reves, Frances Graham, and Robert Gibbs the class representatives.[12] Robertson thus no longer represented the Class, but only the Co-op. Before trial, Robertson and the Class settled with all defendants except Arthur Young and Jack White's legal representatives.[13]

Robertson and the Class asserted seven claims against Arthur Young. Four of these claims are relevant to this appeal: (1) Robertson's claim that Arthur Young breached its auditing contract with the Co-op because the firm did not perform its audits in accordance with generally accepted accounting principles and auditing standards; (2) the Class' claim that Arthur Young induced the purchase of demand notes through the concealment of the Co-op's financial position in violation of 15 U.S.C. § 78j(b) and 17 C.F.R. § 240.10b-5; (3) the Class' claim that Arthur Young induced the purchase of demand notes though the concealment of the Co-op's financial position in violation of Arkansas securities law; and (4) Robertson's and the Class' claim that Arthur Young was a material participant in the operation and management of the Co-op, in violation of the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C.

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[12] Future references to the noteholders will be to the "Class."

[13] Subsequent to trial, Robertson and the Class settled with White's lawyers as well.

§§ 1961-1968. Arthur Young then cross-claimed against the Co-op's Board of Directors, seeking contribution.

Before trial, the district court dismissed Robertson's action for securities fraud and Robertson's and the Class' breach of contract claim. *See Robertson v. White (Robertson I)*, 633 F. Supp. 954, 974, 976 (W.D. Ark. 1986). The district court also determined before trial that the demand notes were securities under both federal and Arkansas law. *See Robertson v. White (Robertson II)*, 635 F. Supp. 851, 865 (W.D. Ark. 1986). Arthur Young then moved for summary judgment on Robertson's and the Class' RICO claim, which the district court granted. *See Robertson v. White (Robertson III)*, Nos. 85-2044, 85-2096, 85-2155, 85-2259, slip op. at 116 (W.D. Ark. Oct. 15, 1986).

Trial commenced on October 22, 1986, and lasted approximately a month. Robertson's and the Class' witnesses consisted mainly of Board members, accounting, legal, and appraisal experts, and Arthur Young personnel. Arthur Young's witnesses consisted mainly of Board members, a legal expert, and two state court clerks.[14]

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[14] While reviewing the trial transcript after oral argument, we noticed that Board member Larry Heatherington, who was not listed in the transcript's table of contents, did testify. *See* 2 Tr. at 201-40. We also noticed that at least one part of the trial was not transcribed, namely, the closing argument of counsel for Jack White's law firm. *See* 16 Tr. at 130-33. Because of our concern with the integrity of the transcript, we requested counsel for Arthur Young and the Class to provide us with a list of the witnesses who testified. Robertson's list, which Arthur Young agreed was accurate, does not include Heatherington. We can only conclude that both parties relied on the transcript's various tables of contents. As a result, we still have

(Continued on following page)

After trial, the jury found that Arthur Young had committed both state and federal securities fraud.[15] The jury found that the Class' damages as a result of the fraud totaled $6,121,652.94.

After the jury returned its verdict, the district court asked the parties to make all motions that might affect the judgment. Responding to these motions in a post-trial memorandum, the district court decided that sums the Class had already received as a result of settlements should offset the jury's verdict. *See Robertson v. White (Robertson IV)*, Nos. 85-2044, 85-2096, 85-2155, 85-2259, slip op. at 37 (W.D. Ark. Feb. 5, 1987). The district court also denied Arthur Young's motions for judgment notwithstanding the verdict (JNOV) on the state and federal securities claims. *Id.* at 49, 61. Finally, the district court rejected Arthur Young's argument that the court wrongly denied the firm's contribution claim. *Id.* at 54.

The district court's final judgment as regards Arthur Young was as follows:

> Arthur Young is ordered to pay to the Class $6,121,652.94, plus prejudgment interest, attorney fees (only on the state securities claim) and

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(Continued from previous page)

reservations about the trial transcript's accuracy. Because apparently neither of the parties share our reservations, we will treat it as accurate.

[15] Although not relevant to the issues on appeal, we note that the jury also found that Arthur Young negligently performed the Co-op's 1981 and 1982 audits, that the Co-op was contributorily negligent, and that Arthur Young had not committed common-law fraud in its performance of those audits.

> costs, under both state and federal claims, subject to a credit in the amount of $5,774,780, conditional on settlements with the Class being approved. The judgment shall bear prejudgment interest and carry an award of fees under the state act, and prejudgment interest under the federal securities law claims. Questions relating to the eligibility for fees under the federal claim, and the amount of any fees, shall be later determined. The court shall set a schedule for plaintiffs to file a bill of costs and a petition to establish the amount of prejudgment interest and fees due. The Class shall be allowed the larger net recovery under this Count, after allowing credits and determining fees, interest and costs.

Amended Judgment Order, Nos. 85-2044, 85-2096, 85-2155, 85-2259 (W.D. Ark. Apr. 23, 1987). Arthur Young, the Class, and Robertson appealed the various judgments, rulings and orders.

K. Subsequent History

This case first came before us in 1988. *See Arthur Young & Co. v. Reves*, 856 F.2d 52 (8th Cir. 1988). At that time we reversed the district court's judgment on the threshold issue of whether the demand notes were securities under federal or Arkansas law, holding that they were not. *See id.* at 55. Subsequently, the Supreme Court vacated our opinion and reversed, holding that the notes were securities within the meaning of § 3(a)(10) of the Securities Act of 1934, codified at 15 U.S.C. § 78c(a)(10) (1988). *See Reves v. Ernst & Young*, 110 S. Ct. 945, 953

(1990). On remand, we now address the plethora of issues the parties originally raised on appeal.

II.

A. Class Certification

Arthur Young argues as a threshold matter that the district court erred in certifying the Class. "A district court has broad discretion in determining whether to certify a class, and its determination will not be overturned absent a showing that it abused its discretion." *Gilbert v. City of Little Rock,* 722 F.2d 1390, 1399 (8th Cir. 1983), *cert. denied,* 466 U.S. 972 (1984). The Class in this case consisted of all persons who had claims against Arthur Young, as well as the other defendants, "arising out of or based upon the . . . demand notes." Sept. 27, 1985 Certification Order, JA at 1736. Although the record is far from clear on this point, it appears that the Class was made up of 1,685 people who bought demand notes from February 1980 until the Co-op's bankruptcy in February 1984.[16] The district court decided to certify the Class after reviewing de novo the United States magistrate judge's proposed findings and recommendations. The magistrate judge had concluded, after reviewing ample evidence and considering the relevant factors, that the proposed class of noteholders unquestionably satisfied the requirements of Fed. R. Civ. P. 23. On the record before us, we find no abuse of discretion.

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[16] For the purposes of the federal and state securities fraud claims, the Class consisted of all those who purchased notes after Arthur Young's first audit report to the Board on April 22, 1982.

B. Robertson's Breach of Contract Claim

Robertson argues that the district court erred in dismissing his breach of contract of claim against Arthur Young. In Count V of the complaint, Robertson alleged that Arthur Young breached its agreements with the Co-op to conduct the 1981 and 1982 audits in accordance with generally accepted accounting principles and auditing standards. Robertson asked that Arthur Young be held liable for all damages it caused and that it return the fees the Co-op had paid it for services rendered. The district court dismissed Robertson's claim on the ground that the claim alleged misfeasance, i.e., that Arthur Young performed the Co-op's audits in a deficient manner, and that under Arkansas law, misfeasance is a tort, and not a contract, claim. *See Oliver v. Bluegrass Resources Corp.*, 678 S.W.2d 769, 770 (Ark. 1984); *McClellan v. Brown*, 632 S.W.2d 406, 407 (Ark. 1982); *Morrow v. First Nat'l Bank*, 550 S.W.2d 429, 431 (Ark. 1977). We also note that under Arkansas law, the trial court may determine whether an action sounds in tort or contract. *See L.L. Cole & Son, Inc. v. Hickman*, 665 S.W.2d 278, 281 (Ark. 1984).

Robertson concedes in his brief that his breach of contract claim is based on Arthur Young's misfeasance. He contends, however, that Arkansas' distinction between tort-based misfeasance claims and contract-based nonfeasance claims was not intended to prevent a party with a misfeasance claim from bringing a breach of contract cause of action. Robertson, however, adduces no support for this contention. It is clear that Robertson raises this issue on appeal because although the jury found that Arthur Young negligently performed the audits, it also found that the Co-op was contributorily

negligent, a defense which Robertson admits is fatal to his negligence claim. Robertson and Class Brief at 64.

Because under Arkansas law Robertson's breach of contract claim actually sounds in tort, we conclude that the district court properly dismissed it.

C. The RICO Claim

The Class argues that the district court improperly granted summary judgment in favor of Arthur Young on its RICO claim. The Class alleged in its complaint that Erwin, Drozal, and Cabaniss conducted or participated in the affairs of the Co-op, committing both mail fraud and securities fraud, in violation of 18 U.S.C. § 1962(c), which provides: "It shall be unlawful for any person employed by or associated with any enterprise engaged in, or the activities of which affect, interstate or foreign commerce, to conduct or participate, directly or indirectly, in the conduct of such enterprise's affairs through a pattern of racketeering activity. . . . "

Summary judgment is proper where, viewing the evidence in the light most favorable to the nonmoving party, and giving that party the benefit of all reasonable inferences to be drawn from that evidence, the movant is entitled to judgment as a matter of law. *See Agristor Leasing v. Farrow*, 826 F.2d 732, 734 (8th Cir. 1987). Viewing the evidence in the light most favorable to the Class, we agree with the district court that, as a matter of law, Arthur Young's involvement with the Co-op did not rise to the level required for a RICO violation. In *Bennett v. Berg*, 710 F.2d 1361 (8th Cir.) (en banc), *cert. denied*, 464

U.S. 1008 (1983), we addressed the nature of the participation required of a RICO defendant before liability is appropriate: "A defendant's participation must be in the conduct of the affairs of a RICO enterprise, which ordinarily will require some participation in the operation or management of the enterprise itself." *Id.* at 1364. Arthur Young's involvement with the Co-op was limited to the audits, meetings with the Board of Directors to explain the audits, and presentations at the annual meetings. In the course of this involvement it is clear that Arthur Young committed a number of reprehensible acts, but these acts in no way rise to the level of participation in the management or operation of the Co-op.

The Class contends that we should follow the Eleventh Circuit's decision in *Bank of Am. Nat'l Trust & Sav. Ass'n v. Touche Ross & Co.*, 782 F.2d 966 (11th Cir. 1986), where that court stated that it "is not necessary that a RICO defendant participate in the management or operation of the enterprise." *Id.* at 970. We are aware of the inconsistencies between the circuits regarding the necessary level of participation for RICO liability. *See Yellow Bus Lines v. Drivers, Chauffeurs & Helpers Local Union 639*, 913 F.2d 948, 952-55 (D.C. Cir. 1990) (en banc) (reviewing the varied approaches to the participation requirement taken by the Second, Fourth, Fifth, Seventh, Eighth and Eleventh Circuits and adopting the Eighth Circuit's standard), *cert. denied*, No. 90-872 (U.S. June 17, 1991). But until the Supreme Court rejects our standard or this court en banc overrules *Bennett*, we are bound to follow that decision. Therefore, we conclude that the district court properly granted summary judgment in favor of Arthur Young on the Class' RICO claim.

D. Demand Notes and Arkansas Law

Arthur Young next argues that the district court erred in holding that the Co-op's demand notes were securities under Arkansas law. We review de novo the district court's ruling on this state law issue. *See Salve Regina College v. Russell,* 111 S. Ct. 1217, 1221 (1991). The district court based its conclusion on three considerations: the legislative history of Arkansas' securities laws; Arkansas' broad, protectionist approach to securities regulation; and federal case law. *See Robertson II,* 635 F. Supp. at 855-65. As regards the third consideration, another Arkansas federal court has observed that "[t]he Arkansas definition of a security is essentially identical to the definition under federal securities laws." *See First Fin. Fed. Sav. & Loan Ass'n v. E.F. Hutton Mortgage Corp.,* 652 F. Supp. 471, 475 (W.D. Ark.), *aff'd,* 834 F.2d 685 (8th Cir. 1987). We have carefully considered the district court's comprehensive legal analysis of this issue, and conclude, based on this analysis and the Supreme Court's decision that the demand notes are securities under federal law, that the demand notes are also securities under Arkansas law.

E. The State Securities Fraud Claim

Arthur Young next argues that the district court erred in denying its motion for JNOV on the state securities fraud claims. In reviewing a district court's denial of a motion for JNOV, we

> must consider the evidence in the light most favorable to the prevailing party, assume that the jury resolved all conflicts of evidence in

> favor of that party, assume as true all facts which the prevailing party's evidence tended to prove, [and] give the prevailing party the benefit of all favorable inferences which may reasonably be drawn from the facts.

Atlas Pile Driving Co. v. DiCon Fin. Co., 886 F.2d 986, 989 (8th Cir. 1989). We will affirm the denial, "if in light of the foregoing, reasonable jurors could differ as to the conclusion that could be drawn from the evidence." *Id.*

Arthur Young argues that even accepting all of the Class' allegations as true, it cannot be held liable for securities fraud under Arkansas law. Under Arkansas law, civil liability for securities fraud exists for any person who

> [o]ffers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they are made, not misleading, the buyer not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

Ark. Stat. Ann. § 23-42-106(a)(l) (B) (1987).[17] Arthur Young contends that it cannot be held liable under

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[17] At the time of trial, this section was codified as Ark. Stat. Ann. § 67-1256(a)(2) (1980 Replacement). Section 67-1256 was modeled after § 410 of the Uniform Securities Act. Section 410(a)(1)(2) of the Uniform Act in turn was modeled after § 12(2) of the Securities Act of 1933, codified at 15 U.S.C. § 771(2) (1988).

§ 106(a) because it was neither an offerer or seller of securities. The Class does not contest this point, arguing that Arthur Young was not charged with primary liability under § 106(a), but with secondary liability under Ark. Stat. Ann. § 23-42-106(c), which provides:

> Every person who controls a seller liable under subsection (a) of this section . . . ; every partner, officer, or director of such a seller or purchaser; every person occupying a similar status or performing a similar function; every employee of such a seller or, purchaser who materially aids in the sale; and every broker-dealer or agent who materially aids in the sale are [sic] also liable jointly and severally with, and to the same extent as, the seller or purchaser, unless the nonseller or nonpurchaser who is so liable sustains the burden of proof that he did not know and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.[18]

Section 106(c) expressly creates two types of secondary liability for securities fraud, control person liability and aiding and abetting liability. *See, e.g., Hogg v. Jerry*, 773 S.W.2d 84, 87 (Ark. 1989). In denying Arthur Young's motion for JNOV, the district court reasoned that because Arthur Young "originated" the material statements that were used to sell the demand notes, "it obviously had the power to 'control' the content of those statements." *Robertson IV*, slip op. at 47. Arthur Young contends that the proper test for control person liability is whether the

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[18] At the time of trial, this section was codified as Ark. Stat. Ann. § 67-1256(b) (1980 Replacement).

defendant "actually participated in (*i.e., exercised* control over) the operations of the corporation in general," and if so, whether the defendant "possessed the power to control the specific transaction or activity upon which the primary violation is predicated." *See Metge v. Baehler*, 762 F.2d 621, 631 (8th Cir. 1985) (emphasis in original), *cert. denied sub nom. Bankers Trust Co. v. Metge*, 474 U.S. 1072 (1986). We note in passing that Arthur Young certainly did not direct the Co-op's operations. We need not determine, however, whether the test for control person liability under 15 U.S.C. § 77o (1988) we established in *Metge* also applies to the Arkansas securities laws. Rather, we believe that the other type of secondary liability for securities violations, aiding and abetting liability, applies to the facts of this case.

Section 106(c) explicitly makes liable for securities fraud any employee of the seller who materially aids in the sale of the security. As the Alabama Supreme Court has observed concerning its version of the same statute:

> A third category under the Alabama Act that goes beyond the comparable federal provision enumerates persons who cannot properly be considered control persons, such as employees of the seller or broker-dealers or agents who may have participated in the sale. The latter persons are included on the basis of what may be considered an express statutory aiding and abetting theory, since the employee, broker-dealer or agent must have "materially aid[ed] in the sale." Therefore, to hold a person liable a plaintiff need not show any active connivance or participation by the alleged control person, except in the case of an employee, broker-dealer,

> or agent; all he need do is establish the defendant's status, either as a controlling person, a partner, or an occupant of some other statutory classification . . . plus the fact of the seller's liability. The defendant then is left with only one defense. . . . He may show that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the seller's liability is alleged to exist.

Foster v. Jesup & Lamont Sec. Co., 482 So. 2d 1201, 1207 (Ala. 1986) (quoting Rediker, *Alabama's "Blue Sky Law" – Its Dubious History and Its Current Renaissance*, 23 Ala. L. Rev. 667, 714 (1971)).[19]

The district court, in denying Arthur Young's motion for JNOV on this issue, did not discuss § 106(c), but instead relied on an amalgam of rather tenuous theories.

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[19] The Alabama statute provides:

> Every person who directly or indirectly controls a seller liable under subsection (a) of this section, every partner, officer or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such a seller who materially aids in the sale and every broker-dealer or agent who materially aids in the sale are [sic] also liable jointly and severally with and to the same extent as the seller, unless the nonseller who is so liable sustains the burden of proof that he did not know and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist.

Ala. Code § 8-6-19(b) (1984), *quoted in Foster*, 482 So. 2d at 1208 n.22. Section 8-6-19(b), like the Arkansas statute, is based on § 410 of the Uniform Securities Act. *See id.* at 1207.

See Robertson IV, slip op. at 40-48. Nonetheless, we believe the district court's instruction to the jury on the state securities claim fulfilled the requirements of § 106(c). The district court instructed the jury that to hold Arthur Young liable for violating Arkansas' blue sky law, it had to find: (1) that the Co-op sold demand notes to the Class by means of untrue statements or omissions of material facts; (2) that the Class did not know of the untrue statements or the omissions;[20] (3) that the untrue statements or the omissions "originated" with Arthur Young; (4) that Arthur Young knew that the statements were being communicated to the Class, and that they were material, "being of the kind and nature that a reasonable person would foreseeably rely on them;" and (5) that Arthur Young knew the statements were false when it made them. 18 Tr. at 79-80. Thus, the jury could only hold Arthur Young liable if it concluded that Arthur Young originated the untrue statements or omissions, knew that the statements were communicated to the Class, and knew that the Class would rely on them to purchase the demand notes; in other words, that Arthur Young "materially aided" in the sale of the demand notes. We note that the trial evidence provides ample support for the jury's verdict against Arthur Young on this issue.

Because we believe this instruction generally comports with the requirements of § 106(c), the only issue

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[20] Arthur Young also contends that the Class did not satisfy its burden of proof that it did not know of the omissions. That, however, is the theory behind the Class' securities claim in general. We believe that on the facts of this case, a sufficient showing was made.

that remains is whether the district court's failure to instruct the jury that Arthur Young was not liable if it did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the Co-op's liability was alleged to exist, constitutes a ground for reversal. *See* Ark. Stat. Ann. § 23-42-106(c). We think not. The district court instructed the jury not to hold Arthur Young liable unless the firm "originated" the linchpin of the securities fraud. By establishing such a high threshold for liability, the district court, perhaps unintentionally, made sure that the jury would not hold Arthur Young liable if it did not know of the facts giving rise to the fraud. Therefore, that no specific instruction was given on this defense does not constitute a ground for reversal because the instruction that was given achieved the same result.

In sum, we believe that Arkansas law does provide for secondary liability for securities fraud in this case. The district court's instructions on this issue, while not precisely comporting with the requirements of § 23-42-106(c), did generally meet those requirements. As a result, the jury could have held Arthur Young liable only if it concluded that the firm materially aided in the sale of the demand notes. Thus, we conclude that the district court properly denied Arthur Young's motion for JNOV on this issue.

F. The Rule 10b-5 Claim

1. Background

Arthur Young next argues that the district court erred in denying its motion for JNOV on the federal securities

claim because it was entitled to judgment as a matter of law. Rule 10b-5[21] provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . .
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

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[21] Rule 10b-5 implements 15 U.S.C. § 78j (1988), which states in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe. . . .

The Supreme Court has referred to § 10b as a " 'catchall' clause to enable the Commission 'to deal with new manipulative [or cunning] devices.' " See *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976) (bracketed material in original).

17 C.F.R. § 240.10b-5 (1990). The purpose behind Rule 10b-5 is to "transcend the gaps and limits of the common law actions available to securities traders injured by false representations or failures to disclose." R. Clark, Corporate law 310 (1986). The rule has been referred to as "a judicial oak which has grown from little more than a legislative acorn," *see Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 737 (1975) (Rehnquist, J.), and as "a horse of dubious pedigree but very fleet of foot." *See* L. Loss, Fundamentals of Securities Regulation 820 (1983). Our review of the case law has brought home the accuracy of these characterizations.

The essential components of a Rule 10b-5 claim are scienter, causation, and damages. *See Abbey v. Control Data Corp. (In re Control Data Sec. Litig.)*, No. 90-5107, slip op. at 4 (8th Cir. May 10, 1991). Primarily at issue in this case is causation, which has two elements. To satisfy the first element, a plaintiff must prove that the allegedly fraudulent acts caused the plaintiff to purchase the securities. *See Harris v. Union Elec. Co.*, 787 F.2d 355, 366 (8th Cir.), *cert. denied*, 479 U.S. 823 (1986). We have variously characterized this showing as a type of "causation in fact," *see Continental Grain (Austl.) Pty. Ltd. v. Pacific Oilseeds, Inc.*, 592 F.2d 409 (8th Cir. 1979), "but for causation," *see Harris*, 787 F.2d at 366, "reliance," *see Austin v. Loftsgaarden*, 675 F.2d 168, 177 (8th Cir. 1982), or as satisfying Rule 10b-5's "in connection with the purchase or sale of any security" requirement. *See Forkin v. Rooney Pace, Inc.*, 804 F.2d 1047, 1049 (8th Cir. 1986).[22] In the

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[22] Indeed, the district court instructed the jury in this case: "The 'in connection with' aspect of this element is satisfied if

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lingua franca of Rule 10b-5 cases, however, this showing is usually referred to as "transaction causation." *See. e.g., Wilson v. Ruffa & Hanover, P.C.*, 844 F.2d 81, 86 (2d Cir. 1988); *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928, 931 (7th Cir.), *cert. denied*, 488 U.S. 926 (1988); *Zoelsch v. Arthur Andersen & Co.*, 824 F.2d 27, 35 n.5 (D.C. Cir. 1987); *see also* Merritt, *A Consistent Model of Loss Causation in Securities Fraud Litigation: Suiting the Right to Fit the Wrong*, 66 Tex. L. Rev. 469, 471-72 (1988) (discussing transaction causation). Thus, for consistency's and simplicity's sake, we will refer to this showing as "transaction causation."

To satisfy the second causation element the plaintiff must prove that the allegedly fraudulent acts caused the plaintiff's economic harm. *See Austin*, 675 F.2d at 178. As with transaction causation, we have characterized this showing as a type of "causation in fact," *see Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713, 719 (8th Cir. 1978); *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 562 F.2d 1040, 1049 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978), although the two showings are analytically distinct. Again, endeavoring to maintain some consistency with our sister circuits, *see, e.g., Bastian v. Petren Resources Corp.*, 892 F.2d 680, 683-84 (7th Cir.), *cert. denied*, 110 S. Ct. 2590 (1990); *Wilson*, 844 F.2d at 85; *Elias v. Arthur Andersen & Co. (In re Financial Corp. of Am. Shareholder Litig.)*, 796 F.2d 1126, 1130 (9th Cir. 1986), and

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you find that there was some substantial nexus or relation between the allegedly fraudulent conduct and the sale or purchase of securities." 18 Tr. at 73.

the commentators, *see, e.g.*, Merritt, 66 Tex. L. Rev. 469 *passim*, we refer to this showing as "loss causation."

2. Transaction causation

With regard to causation, Arthur Young first argues that it is entitled to judgment as a matter of law because no one from the Class testified that they heard Arthur Young's presentation at the Co-op's annual meetings and thereafter bought demand notes. Because the Class' claim was based on Arthur Young's misrepresentations at the annual meetings, the firm contends, the Class had to prove that it relied on those misrepresentations in buying the demand notes. *See Vervaecke*, 578 F.2d at 717. The Class' failure to offer evidence of transaction causation, Arthur Young concludes, is fatal to its Rule 10b-5 claim.

The Class responds that because its claim is based primarily on Arthur Young's nondisclosure of material information about the Co-op's financial health, it is entitled to a rebuttable presumption of transaction causation. In making this argument, the Class relies on a long line of cases in which this court has stated that where the defendant's alleged conduct involves primarily a failure to disclose, the plaintiff need not prove transaction causation; instead, such causation will be inferred if the withheld information was material. *See Barnes v. Resource Royalties, Inc.*, 795 F.2d 1359, 1367 (8th Cir. 1986), *cert. denied sub nom. McPherson v. Barnes*, 110 S. Ct. 1129 (1990); *Harris*, 787 F.2d at 366; *Austin*, 675 F.2d at 177; *St. Louis Union Trust Co.*, 562 F.2d at 1048-49. The inference is not conclusive; rather, it creates a rebuttable presumption of transaction causation. *See. e.g., Barnes*, 795 F.2d at 1367.

a. Nature of the Class' Claim

The sub-issue thus becomes whether the Class' Rule 10b-5 claim is based on misrepresentation or nondisclosure. The district court concluded that the Class' claim was based on a nondisclosure theory and instructed the jury accordingly.[23] This is a conclusion of law that we review de novo. *See Vervaecke*, 578 F.2d at 718 n.2. Of great relevance in determining this issue is how a claimant pleads its Rule 10b-5 claim: "While [plaintiff] tries to present this case to us as a case involving primarily nondisclosure, we have carefully examined the pleadings and do not view it as such." *See id.* at 717. In this case, the Class' complaint states its nondisclosure theory: "Defendants . . . are liable because the accountants knew that they were inducing or causing the purchase of demand notes through *concealment* of the Co-op's financial condition." JA at 51 (emphasis added). We recognize that there is some analytical difficulty in separating misrepresentations from nondisclosures, because misrepresentations often result from the withholding of some material fact. On the facts and the pleadings in this case, however, we

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[23] The district court instructed the jury:

> The second element which the Class must prove by a preponderance of the evidence is that the Class justifiably relied upon the defendant's statements or conduct. However, in order to satisfy this element, the Class need not prove that the Class actually relied on defendant's conduct. Rather, plaintiff's [sic] can satisfy his burden if he proves that the defendant sought to be charged omitted to state a fact to him, and that the omitted fact was material.

18 Tr. at 74-75.

believe that the district court properly characterized this claim as one involving primarily nondisclosure.

Because the Class' claim was premised on a theory of nondisclosure, the Class was entitled to a rebuttable presumption that transaction causation had been shown. Although Arthur Young had notice in the early stages of this action that the Class was going to use the nondisclosure-based rebuttable presumption, *see* Proposed Report and Recommendation on Class Certification, JA at 1454 ("Reliance is unlikely to be an issue in a nondisclosure case. . . . "), it did not attempt to rebut the presumption. For Arthur Young to argue now that it was entitled to judgment as a matter of law because the Class did not show transaction causation is a bold move indeed.[24]

b. Duty to Disclose

Arthur Young raises a second sub-issue with regard to transaction causation, namely, that it could only be held liable for nondisclosure if it had a duty to disclose, and that because it had no such duty, it was entitled to judgment as a matter of law. In making this argument, Arthur Young relies on *Chiarella v. United States*, 445 U.S. 222 (1980), where the Supreme Court stated that nondisclosure is actionable under Rule 10b-5, but that "such liability is premised upon a duty to disclose arising from

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[24] We note that the district court failed to instruct the jury that the presumption of transaction causation (reliance) was rebuttable. However, Arthur Young has not raised this as a ground for reversal, which is understandable in light of its failure even to attempt to rebut the presumption.

a relationship of trust and confidence." *Id.* at 230.[25] Arthur Young argues that because there is no evidence that it had contacts with the Class, it had no relationship with the Class, and that it thus was under no duty to disclose.

A relationship for purposes of Rule 10b-5 liability, however, requires neither a "physical presence nor face to face conversation." *See SEC v. Washington County Util. Dist.*, 676 F.2d 218, 223 (6th Cir. 1982) (footnote omitted). Rather, whether a relationship exists that gives rise to a duty to disclose depends on the circumstances of the individual case. *See Roberts v. Peat, Marwick, Mitchell & Co.*, 857 F.2d 646, 653 (9th Cir. 1988) (per curiam), *cert. denied*, 110 S. Ct. 561 (1989); *Jett v. Sunderman*, 840 F.2d 1487, 1493 (9th Cir. 1988); *Windon Third Oil & Gas Drilling Partnership v. Federal Deposit Ins. Corp.*, 805 F.2d 342, 347 (10th Cir. 1986), *cert. denied*, 480 U.S. 947 (1987); *Rudolph v. Arthur Andersen & Co.*, 800 F.2d 1040, 1043 (11th Cir. 1986), *cert. denied*, 480 U.S. 946 (1987); *First Va. Bankshares v. Benson*, 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied sub nom. Walter E. Heller & Co. v. First Va. Bankshares*, 435 U.S. 952 (1978). The Fifth, Ninth, and Eleventh Circuits

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[25] Before *Chiarella*, this court had stated that the duty to disclose came from Rule 10b-5 itself. *See Myzel v. Fields*, 386 F.2d 719, 740 (8th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968). This statement is no longer accurate. *See, e.g., Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490, 496 (7th Cir. 1986) ("[T]his duty does not come from § 10(b) or Rule 10b-5; if it did the inquiry would be circular. The duty must come from a . . . relation outside securities law.").

have established a number of factors to be used in evaluating those circumstances, including (1) the parties' relative access to the information; (2) the benefit the defendant derives from the sale of the securities; (3) the defendant's awareness of the plaintiff's reliance on the defendant in making investment decisions; and (4) the defendant's role in initiating the sale. *See Jett*, 840 F.2d at 1493;[26] *Rudolph*, 800 F.2d at 1043; *First Va. Bankshares*, 559 F.2d at 1314; *see also In re National Smelting of N.J., Inc. Bondholders Litig.*, 722 F. Supp. 152, 170-71 (D.N.J. 1989) (applying the same analysis). In addition, the Eleventh Circuit also considers (5) the extent of the defendant's knowledge; (6) the significance of the nondisclosure; and (7) the extent of the defendant's participation in the fraud. *Rudolph*, 800 F.2d at 1043.

Therefore, we must examine the facts of this case in light of these factors to determine whether a relationship giving rise to a duty to disclose existed between the Class and Arthur Young at the time of the nondisclosure. The first factor, the parties' relative access to information, supports a duty to disclose: Arthur Young was the source of some of the information that was not disclosed, e.g., the assumption about the Co-op's always having owned White Flame, and was aware of the critical information that if White Flame was given a lower value, the Co-op's

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[26] In *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990) (en banc), *cert. denied*, 111 S. Ct. 1621 (1991), the Ninth Circuit stated that it would no longer use the "flexible duty" test. *Id.* at 1570. However, this statement was limited to the scienter element of a Rule 10b-5 violation and thus appears not to alter the duty to disclose analysis.

net worth would be wiped out.[27] The second factor, the benefit the defendant derives from the sale, supports a duty to disclose in this case, but only weakly. Arthur Young did benefit from the sale of the demand notes, but only because the Co-op was a client and the demand notes were the Co-op's primary source of financing. This sort of indirect benefit, however, does not count for much.

The third factor, the defendant's awareness that the plaintiff relied on it in making investment decisions, also supports a duty to disclose here. Arthur Young knew that the demand notes were a risky source of financing and that bad news could cause a run on the Co-op. Conversely, Arthur Young must also have known that good news would ensure that people continued to buy demand notes. It is important to understand the nature of the Co-op's demand note clientele. The Class consists primarily of farmers, pensioners, and others who lived in and around Van Buren, Arkansas. Many of the Class members invested all of their savings in the Co-op's demand note program. These were not sophisticated investors. Thus Arthur Young had to know that good news about the Co-op's finances, or even the lack of bad news, would cause people to invest in the Co-op. As the Fifth Circuit has observed: "[T]he danger of misleading the public through a public accountant's knowing issuance of a false

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[27] Although this factor supports a duty to disclose in this case, we do not afford it great weight in light of dicta found in the *Chiarella* decision: "A duty arises from the relationship between parties . . . and not merely from one's ability to acquire information because of his position in the market." 445 U.S. at 231-32 n.14.

opinion is obvious. A public accountant performs an important public function and must be aware that the public places great faith in the probity of its opinions." *Fine v. American Solar King Corp.*, 919 F.2d 290, 298 (5th Cir. 1990), *petition for cert. filed*, 59 U.S.L.W. 3615 (U.S. Mar. 4, 1991) (No. 90-1372), *motion to defer consideration of petition granted*, 59 U.S.L.W. 3769 (U.S. May 13, 1991).

Although the fourth factor, the defendant's role in initiating the transaction, does not support a duty to disclose because Arthur Young played no active role in the purchase of the demand notes, the final three factors do. The fifth factor, the extent of the defendant's knowledge, clearly weighs in favor of a duty to disclose in this case because it is undisputed that Arthur Young knew everything the Class wishes had been disclosed. The sixth factor, the significance of the nondisclosed matters, also obviously supports the duty to disclose. Finally, the seventh factor, the extent of the defendant's involvement, supports the duty as Arthur Young's involvement ranged from its conclusion about the acquisition of White Flame to its valuation of the plant to its actions at the Co-op's annual meetings. Therefore, based on these factors, Arthur Young had a relationship to the Class such that the Class had placed its "trust and confidence," *Chiarella*, 445 U.S. at 232, in the firm.

Arthur Young argues that it would be unfair to impose a duty to disclose on it in this case because it had no means to satisfy that duty. This claim is preposterous. Arthur Young knew the condensed financial statements were misleading because they did not discuss the problems with White Flame. At the annual meetings Arthur Young could have said something, but simply chose not

to. We wonder how difficult it would have been for Arthur Young, at either of the annual meetings, to inform the audience that there was something suspicious about the acquisition of White Flame, that Arthur Young had concluded that the Co-op had always owned the plant and relied on Kuykendall's numbers in valuing it, and that if White Flame were carried at a lower value, the Co-op might have a negative net worth. Given the importance of that information, the nature of the Co-op and the people who invested in it, the Co-op's location in a relatively rural area, and the interest of local news organizations in the Co-op's affairs, it seems sure that the Class would have heard what it now dearly wishes it had heard. Thus, Arthur Young could have satisfied its duty with perhaps two of the ten minutes it used to address the annual meetings in 1982 and 1983.[28]

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[28] Arthur Young also relies on a line of Seventh Circuit cases for the proposition that it had no duty to disclose. *See DiLeo v. Ernst & Young*, 901 F.2d 624 (7th Cir.), *cert. denied*, 111 S. Ct. 347 (1990); *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322 (7th Cir. 1989); *LHLC Corp. v. Cluett, Peabody & Co.*, 842 F.2d 928 (7th Cir. 1988); *Barker v. Henderson, Franklin, Starnes & Holt*, 797 F.2d 490 (7th Cir. 1986). These cases, however, do not apply to the case at hand because they all involve claims for aiding and abetting Rule 10b-5 violations against accounting firms that did not blow the whistle on their clients, as opposed to the primary Rule 10b-5 liability asserted here. *See, e.g., Latigo Ventures*, 876 F.2d at 1327 ("It is not the law that whenever an accountant discovers that his client is in financial trouble he must blow the whistle on the client for the protection of investors. . . . "). Moreover, those cases feature vastly different factual circumstances and procedural postures. We do not believe these cases direct the result here.

Based on the unique facts and circumstances of this case, we hold that Arthur Young's relationship with the Class was such that it had a duty to disclose. Because of this duty to disclose, the Class was entitled to a rebuttable presumption of transaction causation. As Arthur Young did not attempt to rebut the presumption of transaction causation, the district court did not err in refusing to grant Arthur Young's motion for JNOV on the ground that the Class had not shown transaction causation.

3. Loss Causation

Arthur Young next argues that the district court erred in not granting its motion for JNOV on the ground that the Class failed to prove loss causation, that is, that Arthur Young's nondisclosure caused the Class, economic harm. *See supra* II.G.1. Arthur Young argues that the Class, economic harm was caused by the Co-op's bankruptcy, which, in turn, was directly precipitated by CFA's refusal to honor the Co-op's line of credit. Thus, Arthur Young argues, there is no loss causation because the bankruptcy was unrelated to the alleged fraud. Arthur Young's contention, while of some merit, is ultimately unavailing because of this court's broad test for loss causation. In our most recent Rule 10b-5 opinion, Chief Judge Lay observed: "Plaintiffs are not required to meet a strict test of direct causation under Rule 10b-5; they need only show 'some causal nexus' between [the defendant's] improper conduct and plaintiff's losses. . . . Traditional tests of proximate cause derived from tort principles are very much germane." *See Abbey v. Control Data Corp. (In re Control Data Corp. Sec. Litig.)*, No. 90-5107, slip op. at 7

(8th Cir. May 10, 1991) (citations omitted).[29] Thus, all the Class needed to show was that the Co-op's bankruptcy was somehow "related" to Arthur Young's nondisclosures. *See St. Louis Union Trust Co.*, 562 F.2d at 1049.

We believe the Class, evidence was sufficient on this issue. The Class showed that the Co-op would have had serious financial problems in 1981 had Arthur Young disclosed the information about White Flame. We are unable to say that Arthur Young's nondisclosure was unrelated to the Co-op's eventual bankruptcy.

Moreover, we note that one of Arthur Young's own exhibits refutes its contention that its nondisclosure was

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[29] The district court's instruction on this issue was based on a theory of proximate cause:

> The fourth element that the trustee must establish by a preponderance of the evidence is that the defendant's conduct was the proximate cause of the injury to the plaintiff.
>
> In order for an act or omission to be considered a proximate cause of the injury, it must be a substantial factor in causing the damage, and the injury must have been either a direct result or a reasonable probable consequence of the act or omission.
>
> In order to satisfy this element, the plaintiff need not prove that the defendant's conduct was the only cause of the plaintiff's injury. It is sufficient if you find that the actions of the defendant were a substantial and significant contributing cause to the injury which the plaintiff suffered.

See 18 Tr. at 78.

unrelated to the Co-op's bankruptcy. That exhibit contains the bankruptcy court's order approving the Co-op's disclosure statement to its creditors, along with the statement itself and the bankruptcy plan of reorganization. The disclosure statement, which the Co-op's bankruptcy counsel prepared, states that there were three reasons for the bankruptcy filing: problems with the Co-op's management, the Co-op's reliance on demand notes for financing, and most importantly for our analysis, *the financial problems associated with White Flame*. *See* AY Ex. 223.

Because a reasonable jury could have found that Arthur Young's nondisclosure contributed to the Co-op's bankruptcy, and hence the Class' injury, we hold that the district court did not err in refusing to grant Arthur Young's motion for JNOV on the issue of loss causation.

4. Scheme to Defraud

Finally, Arthur Young argues that the district court erred because its instructions to the jury on the Rule 10b-5 claim were based on a scheme to defraud theory, that this theory is synonymous with a conspiracy theory, and that the district court had already determined that there was no conspiracy in this case. We do not believe that the limited references to scheme to defraud constitute reversible error in this case. Reading the instructions as a whole, *see Smith v. Hussman Refrigerator Co.*, 619 F.2d 1229, 1245 (8th Cir.) (en banc), *cert. denied*, 449 U.S. 839 (1980), it is clear both that the jury was not required to find any sort of conspiracy, and that Arthur Young's conduct satisfied the elements of a Rule 10b-5 violation.

5. Conclusion

In sum, the district court properly refused to grant Arthur Young's motion for JNOV on the Class' Rule 10b-5 claim. As is apparent, the key to our resolution of this issue is the conclusion that Arthur Young had a duty to disclose material information to the Class. This duty was a necessary prerequisite to the Class' nondisclosure theory and the resulting shift in the burden of proof on the issue of transaction causation. Arthur Young has argued vehemently against the existence of such a duty, claiming, among other things, that finding such a duty will increase the costs of all audits and lessen the amount of accounting oversight because firms will be unwilling to pay the higher prices. This policy-based rationale, however, does not comport with the law, nor with common sense. It must be kept in mind that whether or not a duty exists will be determined on a case-by-case basis, and that the duty to disclose imposed in this case was based on unique facts and circumstances. We certainly doubt that other accounting firms will engage in the type of conduct that Arthur Young did in this case. More particularly, we hope that Arthur Young will not.

G. Arthur Young's Contribution Claim

Arthur Young next argues that the district court erred in not submitting its contribution claim against the Co-op's Board of Directors to the jury. Arthur Young contends that it submitted a contribution instruction on the securities claims, but that the district court did not offer any such instruction. The district court, in denying Arthur Young's motion for a new trial on this issue,

concluded that Arthur Young did not make a specific objection at trial concerning the court's failure to instruct on the contribution claim, and moreover that the instruction Arthur Young allegedly tendered incorrectly stated the law. *Robertson IV*, slip op. at 37.

After reviewing the record, we conclude that the district court properly denied Arthur Young's motion for a new trial on this issue. On November 12, 1986, the district court informed counsel for all parties that they were to meet with his law clerks off the record and discuss the pros and cons of the proffered instructions, and that later all counsel would have an opportunity to go on the record in relation to the instructions. 16 Tr. at 201-03. On November 14, the district court conducted these on-the-record proceedings. At that time the district court stated:

> We are aware, in some detail, of the position of each of you, in relation to the issues that ought to be presented. What I'd like for you to do, because I understand that's all you need to do, in order to make your record to the Court of Appeals, is to tell me which of these instructions you think are wrong or should not be given, what additional instructions you think ought to be given and, very briefly, why. . . . Just do what you know is necessary, so that the Court of Appeals can see that you've made your record in relation to those instructions.

17 Tr. at 6. Counsel for Arthur Young objected to the proposed instructions as to contribution on Robertson's negligence claim against Arthur Young. *Id.* at 25. Counsel, however, mentioned nothing about contribution on the Class' securities claims. *Id.* at 18-26. The next day, counsel

was given another opportunity to go on the record about the instructions after the district court read them to the jury. Counsel raised several new objections at this point, but again mentioned nothing about contribution against the Board on the Class, securities claims. 18 Tr. at 92-94.[30]

Fed. R. Civ. P. 51 states: "No party may assign as error . . . the failure to give an instruction unless that party objects thereto before the jury retires to consider its verdict, stating distinctly the matter objected to and the grounds of the objection." The purpose of Rule 51 is to "compel litigants to afford the trial court an opportunity to correct any error in the instructions and also to prevent the losing party from obtaining a new trial through relying on a possible error in the original trial." *Johnson v. Houser,* 704 F.2d 1049, 1051 (8th Cir. 1983) (per curiam). As Wright and Miller have observed: "This purpose is well understood by the courts and the rule is applied in light of it. The necessity of a retrial is avoided when, by design or through sheer neglect, the losing party fails to make objection at the proper time." 9 C. Wright & A. Miller, Federal Practice and Procedure § 2551 (1971) (footnotes omitted).

We note that Arthur Young might have had a colorable claim for contribution against the directors. Ark. Stat. Ann. § 23-42106(c) specifically provides for contribution in the case of secondary liability for securities fraud.

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[30] Our conclusion that Arthur Young did not object to the failure to instruct based on our review of the transcript is also supported by Arthur Young's failure to indicate in its briefs where it objected.

However, "[e]rror in the instructions not properly objected to is waived unless the error is plain error in the sense that a miscarriage of justice would otherwise result." *Johnson,* 704 F.2d at 1051. The plain error exception is limited to the "exceptional case, in which error has affected seriously the fairness, integrity or public reputation of judicial proceedings." *Id.* at 1052. This is not such an exceptional case, and no miscarriage of justice has occurred, because it is clear that much of the blame for the fraud in this case is placed properly on Arthur Young.

Putting this in some perspective, we note that the jury received 100 instructions in this case; eighty pages in the trial transcript are devoted to the district court's reading of those instructions to the jury. *Id.* at 4-84. Arthur Young now complains about the district court's failure to offer one instruction, when the firm had several days' notice as to when the instructions could be objected to, and at least two opportunities specifically to object to those instructions. Arthur Young could have objected to the failure, but did not. We conclude that the locus of the responsibility for the failure to instruct lies with Arthur Young, and not the district court, and thus that the district court properly denied the firm's motion for a new trial.

H. The Damages

1. Damages Evidence

Arthur Young next raises several issues concerning the damages awarded the Class. As an initial matter, Arthur Young challenges the competency of the Class'

evidence on damages. That evidence consisted of a computer run showing the demand notes purchased between April 22, 1982, when Arthur Young made its first presentation to the Board, and February 23, 1984, when the Co-op declared bankruptcy and the demand notes were frozen in the bankruptcy estate. The computer run showed that the notes purchased between those dates totaled $6,121,652.94. The jury awarded the Class exactly this amount after holding Arthur Young liable for state and federal securities fraud.

Arthur Young raises two main arguments with respect to the competency of the computer print-out. First, it contends that the print-out included the demand notes which had been redeemed within the ninety days before the Co-op's bankruptcy. Arthur Young argues that because these Class members received payment in full on their notes, they have no damages. The Class argues that these noteholders were included because their redemptions would be revoked as preferential transfers, ostensibly under 11 U.S.C. § 547 (1988). Therefore, the Class argues, these "preference" noteholders "were included in the Class as if they actually held notes." Robertson and Class Brief at 43. Robertson and the Class argue that there was no point in forcing Robertson to prosecute actions against all of these individuals if Arthur Young was found liable, because Robertson would just seek a decree to stand in shoes of those noteholders against Arthur Young.[31]

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[31] The preference noteholders had redeemed $1,762,581.41 worth of notes. JA at 439.

Arthur Young's second argument is that the $6.1 million figure for the total number of demand notes sold between April 22, 1982 and February 23, 1984, also includes notes that were bought before April 22, 1982. If an investor partially redeemed a note during that twenty-month period, the remaining funds were re-issued as a new note. The Class' witness on the computer run admitted this at trial: "There was not [sic] assumption, no logic in the program at all to exclude anything at all except by the date of that note. . . . If the date of the note is 4-22-82. If that's what you call a rollover note, then yes, it would be included." 15 Tr. at 35.

We believe that both of these problems warrant reversing the award of damages in this case. Although the facts and the law certainly justify Arthur Young's liability for state and federal securities fraud, the damage award cannot stand. Arthur Young should not be charged with the $1.8 million the preference noteholders redeemed before bankruptcy, because at the time of trial the bankruptcy estate had not yet proceeded against them and there was no guarantee that the estate would succeed. Thus, until those noteholders suffer harm because of the bankruptcy, they have no damages.[32]

Arthur Young should also not be held liable to those whose initial investments in the Co-op occurred before

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[32] We are unable to determine from the record exactly what has happened as regards the preference noteholders. At one point the Class appears to argue that Robertson has not filed actions against them. Robertson and Class Brief at 43. However, in another brief, the Class states that Robertson has filed actions against the preference noteholders. Class' Fees and Costs Brief at 12. This issue should be resolved on remand.

April 22, 1982. In no sense can those noteholders be said to have relied on Arthur Young's nondisclosure (for the Rule 10b-5 claim), nor can it be said that Arthur Young aided the Co-op's commission of securities fraud before it met with the Board (for the state claim). Therefore, we reverse the award of damages and remand for a new trial on this issue. Liability having been established, the Class need only provide evidence of the amount of demand notes purchased for the first time between April 22, 1982[33] and February 23, 1984. This figure will not include the demand notes redeemed within ninety days of bankruptcy unless the district court determines that those noteholders have been injured by the bankruptcy sometime between the original trial and the new trial on damages.

2. Measure of Damages

Arthur Young next argues that the district court erred in applying rescissory damages[34] instead of out-of-pocket damages on the federal securities claim.[35] The district

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[33] If the Class had prevailed only on the Rule 10b-5 claim, the appropriate date would be May 27, 1982, the date of the Co-op's annual meeting.

[34] Rescissory damages "contemplate a return of the injured party to the position he occupied before he was induced by wrongful conduct to enter into the transaction" and are the monetary equivalent of the property at issue. *See* Black's Dictionary 354 (5th ed. 1979).

[35] Arthur Young concedes that rescissory damages are proper under the state securities fraud claim.

court's remedy functioned to transfer the demand notes from the noteholders to Arthur Young, which could then present the notes to the bankruptcy estate for payment. *See Robertson IV,* at 61-62. The district court selected this procedure because it greatly simplified a complex issue; benefited Arthur Young, in that the Co-op's bankruptcy estate had been significantly augmented by the various settlements in this case; and placed the Class in the same position it would have been in but for Arthur Young's fraud. *See id.* at 62-63.

Arthur Young contends that rescissory damages are only available where the defendant's benefit is greater than the plaintiff's harm. In making this argument, Arthur Young relies on *Affiliated Ute Citizens v. United States,* 406 U.S. 128 (1972), in which the Supreme Court stated that "the correct measure of damages . . . is the difference between the fair value of all that the [plaintiff] received and the fair value of what he would have received had there been no fraudulent conduct." *Id.* at 155. Arthur Young ignores, however, a more recent Supreme Court case that also addressed the issue of damages in a Rule 10b-5 case. In *Randall v. Loftsgaarden,* 478 U.S. 647 (1986), the Supreme Court observed: "The issue whether and under what circumstances rescission or a rescissory measure of damages is available under § 10(b) is an unsettled one." *Id.* at 661. The Court, after noting *Affiliated Ute,* continued: "But there is authority for allowing the § 10(b) plaintiff, at least in some circumstances, to choose between 'undoing the bargain . . . or . . . requiring [the defendant] to pay [out-of-pocket] damages.' " *Id.* (quoting L. Loss, at 1133; latter bracketed material in original opinion). The Supreme Court,

however, expressly reserved decision on the point by assuming, *arguendo,* that a rescissory recovery "may sometimes be proper on a § 10(b) claim." *Id.* Therefore, contrary to Arthur Young's assertion, *Affiliated Ute* has not foreclosed the question of whether rescissory damages were appropriate in this case.

This court has previously observed that although Rule 10b-5 damages are normally measured by the plaintiff's out-of-pocket losses, the "out-of-pocket rule is not a talisman." *See Garnatz v. Stifel, Nicolaus & Co.,* 559 F.2d 1357, 1360 (8th Cir. 1977), *cert. denied,* 435 U.S. 951 (1978). In *Garnatz* we remarked further, "Indeed, this court has shown no hesitation in varying that measure when necessary on the facts of a given case," and concluded, "Our function is to fashion the remedy best suited to the harm." *Id.* The Ninth Circuit has even opined that whether rescissory damages are appropriate is within the district court's discretion. *See, e.g., Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 651 F.2d 615, 621 (9th Cir. 1981).

We believe that rescissory damages are best suited to the harm and to the facts of this case. Although we do not believe that simplification alone is a sufficient reason for applying this measure of damages, *see Green v. Occidental Petroleum Corp.,* 541 F.2d 1335, 1343 (9th Cir. 1976) (Sneed, J. concurring) ("Wrongdoing defendants should not be mulcted to make simple the management of a class proceeding under rule 10b-5."), we do believe that rescissory damages are fair to both parties: the Class receives funds immediately, and Arthur Young has an opportunity to recoup from the Co-op's bankruptcy estate the damages it paid to the Class.

Arthur Young argues that rescissory damages are only proper where the plaintiff is in privity with the defendant. Otherwise, Arthur Young argues, it would be required to perform an impossibility: rescind a transaction to which it was not a party. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 555 (5th Cir. Unit A Mar. 1981), *aff'd in part and rev'd in part on other grounds*, 459 U.S. 375 (1983). Arthur Young relies on a sophism to obscure the law, which is that when the circumstances of a case so dictate, privity is not required for the court to award *rescissory damages* in a Rule 10b-5 case. As the Eleventh Circuit has concluded: "Though we recognize the harshness of this result given that the defendants were not the actual sellers of the stock and therefore must 'rescind' by paying an amount they in fact never received, the substantial role played by the defendants provides adequate justification for the award." *Bruschi v. Brown*, 876 F.2d 1526, 1532 (11th Cir. 1989) (quotation omitted). *See also Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974) (holding, in a Rule 10b-5 action, that "as between the innocent purchaser and the wrongdoer, who, though not a privy to the fraudulent contract, nonetheless induced the victim to make the purchase, equity requires the wrongdoer to restore the victim to the status quo.") We conclude that the district court properly determined that a rescissory measure of damages was appropriate based on the facts and circumstances of this case.

3. Calculation of Damages

Arthur Young next argues that even if rescissory damages were appropriate, the district court erred in its final determination of the damages because it included

interest on the notes. Rescissory damages are measured as follows: "[T]he plaintiff is entitled to a return of the consideration paid, reduced by . . . any 'income received' on the security." *Randall*, 478 U.S. at 656. Arthur Young argues that to measure the damages as of February 1984 for all of those who invested earlier than that, and hence earned interest, was error. We agree. Rescissory damages place a plaintiff in the same position she would have been in had she not been induced to enter into the transaction. *See* Black's Dictionary 354 (5th ed. 1979). Therefore, all the Class is entitled to is the return of its investment in the Co-op, not the investment plus its interest. Any interest the Class is entitled to would come as a result of this action, not the Co-op's program.

Unfortunately, we are not able to determine what actually happened as regards the interest on these notes. The Class, witness on the computer run did not testify on this issue and the record contains some confusing information. *See* JA at 440 ("The 'Amount Due' calculation represents the total amount of the notes plus simple interest on the notes at the rate indicated on the computer run minus the interest which was received by individuals on the notes."). Because it appears that the district court did not address this issue in its post-trial memorandum, *see Robertson IV*, at 61-66, and the Class has not addressed it in the briefs on appeal, we believe this is best dealt with on remand. Perhaps the awarded damages did not include interest and Arthur Young is wrong. Or it is possible that Arthur Young is raising this argument for the first time on appeal. On the record before us, however, we are unable to make any determination. Therefore, this issue should also be resolved on remand.

I. The Settlement Credit

The Class contends that the district court erred in crediting $5,744,800[36] in settlement proceeds against the $6,121,652.94 verdict against Arthur Young. During the course of the proceedings in this case, most of the defendants settled with Robertson and the Class. The settlements totaled approximately $8.2 million. Robertson and the Class agreed to split the settlement proceeds, allocating $5.6 million to the Class and $2.6 million to Robertson. It must be remembered that at this stage, the Class consisted of people who had purchased demand notes after February 15, 1980. The jury then determined that Arthur Young was liable for approximately $6.1 million in damages to the people who purchased demand notes after April 22, 1982. Because the district court fully credited the settlement proceeds against the jury's verdict, the Class argues, Arthur Young gets the benefit of settlements with Class members who had no claim against Arthur Young.

Under federal law, where a "settlement payment and the jury's award pertain[ ] inseparably to one and the same loss," the verdict must be credited with the payment on settlement. *See Kassman v. American Univ.*, 546 F.2d 1029, 1035 (D.C. Cir. 1976) (per curiam); *see also Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 50 (2d Cir.) (holding that Rule 10b-5 damages must be offset by amount of settlement), *cert. denied*, 439 U.S. 1039 (1978).

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[36] This is more than the $5.6 million allocated to the Class before trial because it includes settlements reached during trial and other corrections made by the district court. *See* JA at 1434.

Under Arkansas law, settlement payments must be credited against a verdict if the settling party is jointly liable with the party against whom the verdict is rendered. *See* Ark. Stat. Ann. § 16-61-204 (1987) (formerly Ark. Stat. Ann. § 34-1004 (1947)). For joint liability, both parties must be responsible for the same injury. *Id.* § 16-61-201. Even if the parties' tortious acts are temporally separate, if they caused the same injury or loss, the parties are jointly liable. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. First Nat'l Bank of Little Rock*, 774 F.2d 909, 916 (8th Cir. 1985). The district court concluded that Arthur Young and all of the settling defendants were joint tortfeasors, and granted the credit on that ground.

In this case, it is clear that the settlements were not all paid for the same loss. Some of the settling defendants, i.e., Co-op officers and directors, were released from various claims, including claims for common law fraud, negligence, and RICO violations. *See Robertson IV*, at 19. Therefore, under either the federal securities verdict or the Arkansas securities fraud verdict, the district court was not required to credit fully the settlement proceeds.

Having reached this conclusion, we still must address the proper allocation of the settlement proceeds. We must place the Class in the same position that it would have been in if not for Arthur Young's fraudulent acts. Therefore, on remand, the district court should first determine what the Class' damages are, as discussed above. The district court should then pro rata allocate the settlement proceeds to *all* members of the Class and

credit Arthur Young with the settlement proceeds allocated to the post- April 22, 1982, demand note purchasers. Arthur Young thus will not receive the benefit of settlements received by those who had no claims against it, but neither will the Class as a whole be unjustly enriched.

J. Conclusion

As regards the main appeal in this case, we affirm the district court's judgment in all respects except for the award of damages. We reverse that award and remand for a new trial on the issue of damages alone. At that time the district court shall conduct proceedings consistent with this opinion.

III.

Consolidated with the main appeal in this case is Arthur Young's appeal on interest, costs, and fees, and the Class counsel's appeal on the issue of his fees.

A. Interest

Arthur Young challenges the district court's calculation of pre- and postjudgment interest in this case. Because we have remanded for a new trial on the issue of damages, the proper interest will have to be recalculated. To guide the district court, we make the following observations. First, whether to award prejudgment interest is a matter of judicial discretion. *See Blau v. Lehman*, 368 U.S. 403, 414 (1962). Second, even though Arthur Young is entitled to credit against the verdict as discussed above,

Arthur Young is still liable for prejudgment interest on the entire verdict. Again, this is consistent with the rescissory measure of damages used in this case, and contrary to Arthur Young's suggestion, does not operate as a penalty. Third, 28 U.S.C. § 1961 specifically authorizes postjudgment interest, and we believe such interest is appropriate on both the damages and prejudgment interest in this case to compensate the Class for its investment and the interest the investment would have earned if not for Arthur Young's fraud. *See Kaiser Aluminum & Chem. Corp. v. Bonjorno,* 110 S. Ct. 1570, 1576 (1990).

B. Costs

Arthur Young next argues that the district court erred in awarding costs to Robertson and the Class. Arthur Young specifically argues that the district court erred in awarding costs to Robertson's counsel because he did not prevail on any claims and thus was not entitled to costs. *See* Fed. R. Civ. P. 54(d). Arthur Young overlooks the fact, however, that Robertson's counsel represented the Class before the Class counsel was appointed. Robertson and the Class also had a joint prosecution agreement, which provided that they would assist one another at trial. *See* JA at 2435. Having reviewed the transcript, we believe that much of what Robertson's counsel did at trial ultimately benefited the Class. In awarding costs to Robertson's counsel, the district court appears to have taken into consideration Robertson's counsel's lack of success on Robertson's claims, because it only awarded half of the costs requested. However, Robertson's counsel was only entitled to the costs reasonably associated with his representation of the Class. From the record we are

unable to determine whether the district court's costs award was reasonably related to the Class representation. Therefore, we reverse the award and remand for a redetermination of costs for Robertson's counsel.

Arthur Young also challenges the district court's award of costs to the Class. The decision whether to award costs to a prevailing party is committed to the discretion of the district court. *See Boyd v. Ozark Air Lines, Inc.*, 568 F.2d 50, 55 (8th Cir. 1977); Fed. R. Civ. P. 54(d). Arthur Young first contends that the district court's award of $8755 in costs was error because the Class did not meet its burden of proof with regard to evidence of costs. The Class did meet its burden of proof as regards $7378 incurred in providing the initial notice to the Class. *See* JA at 2355-60. Class counsel also attested to approximately $1500 in copying costs, although there is no supporting documentation. List of Co-op Litigation Expenses of Class Counsel, *reprinted in* Arthur Young Brief on Costs, Appendix D. We do not believe that the district court's final award of $8755, however, constitutes an abuse of discretion on the facts of this case.

Arthur Young also argues that the district court erred in finding that it was not a prevailing party or, alternatively, that the district court abused its discretion in denying the firm's petition for costs. We believe that the district court neither erred nor abused its discretion in denying costs to Arthur Young. Arthur Young next argues that the district court's failure to allocate costs among all forty original defendants constituted an abuse of discretion. We disagree, and note also that Arthur Young has failed to adduce any relevant precedent in support of this claim.

C. Fees

Arthur Young next challenges the award of attorney fees to Class counsel under Arkansas law. However, it appears from the record that the district court ultimately decided not to award any attorney fees under Arkansas law, because the larger net recovery was under the federal securities claim. In *Grogan v. Garner,* 806 F.2d 829 (8th Cir. 1986), we stated: "When a federal securities claim overlaps with a pendent state law claim, the plaintiff is entitled to the maximum amount recoverable under any claim." *Id.* at 839. In this case, the maximum amount recoverable was under the federal securities claim, and the district court thus did not award attorney's fees under Arkansas law. *See* Letter from District Court to all Counsel at 4 (Oct. 14, 1987), *reprinted in* Arthur Young Brief on Costs, Appendix B.

D. Class Counsel

Finally, Class counsel appeals the district court's reduction of his fee from the common fund established for the Class out of the various settlements. Class counsel requested that $335,000 of the common fund be allocated to him as a fee. The district court, after much reflection, concluded "given all the circumstances that only someone who 'lived through it' would know, that a reasonable fee for the services performed by [Class counsel] is $240,000." *See* Letter from District Court to all Counsel at 1 (Oct. 20, 1987), *reprinted in* Class Counsel's Brief on Fees, Addendum. After having reviewed the record and the district court's reasoning, although we believe there is

some merit to Class counsel's argument, we find no error in the reduction of his fee.

E. Conclusion

In sum, we affirm the district court's ruling on costs and fees except for its determination of Robertson's counsel's costs. On remand, the district court should recalculate the appropriate interest and redetermine the appropriate costs for Robertson's counsel.

IV.

Accordingly, the judgment of the district court is affirmed in part and reversed in part. In sum, we conclude that the district court: properly certified the Class; properly dismissed Robertson's breach of contract claim; properly granted summary judgment in favor of Arthur Young on the RICO claim; properly ruled that the demand notes were securities under Arkansas law; properly denied Arthur Young's motion for JNOV on the state and federal securities fraud claims; properly denied Arthur Young's motion for a new trial on the contribution issue; erred in part on the damages awarded; erred in granting Arthur Young full credit for settlement proceeds; and properly determined all costs and fees except for the fees for Robertson's counsel. This matter is remanded to the district court for further proceedings as discussed above.

A true copy.

Attest:

CLERK, U. S. COURT OF APPEALS, EIGHTH CIRCUIT.

APPENDIX B

Thomas E. ROBERTSON, Jr., As Trustee of the Farmer's Co-Op of Arkansas and Oklahoma, Inc.; Bob Reves; Frances Graham; Robert H. Gibbs, individually; Robert H. Gibbs, as natural guardian of his minor children Thomas A. Gibbs and Robert H. Gibbs, Jr.,; and Robert H. Gibbs, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds, Plaintiffs, and Intervening Plaintiffs

v.

Jack E. WHITE; J.E.W., Inc.; Valley Feeds, Inc.; Gene Kuykendall and Fred Kuykendall, individually and d/b/a Kuykendall & Kuykendall, a partnership; Oran Moody, Jr. and Michael O. Moody, individually and d/b/a Moody & Moody, a partnership; Arthur Young & Company; Harry C. Erwin; Billy Joe Cabaniss, Jr.; Joseph F. Drozal, Jr.; Charles M. Hanson; Hal Brewer; Waldo Price; Truman O. Boatright; J.O. McClure; Hugh Winfrey, Jr.; M.V. Creech; Charles Bane; E.H. Pritchett, Jr.; Robert Plunkett; Ralph McClure; Jimmy Don Gooch; Jerry Metzer; W.J. Rimmer; Don Sebo; Joe Wayne Harris; James Willis; Dan Ray Core; Harold Davis; Jay Freeman; Jay Neal, Jr.; George Wagnon; Raymond (Jack) Clark; Carl Creekmore and Morril H. Harriman, Jr., individually and d/b/a Creekmore & Harriman, a partnership; E.J. Ball, Kenneth R. Mourton, and Stephen E. Adams, individually and d/b/a Ball, Mourton & Adams, a partnership; Kirit Goradia; Eddie Joe Smith; and John Does 1-20, Defendants.

Nos. 85-2044, 85-2096, 85-2155 and 85-2259.

United States District Court,
W.D. Arkansas,
Fort Smith Division.

April 4, 1986

MEMORANDUM OPINION

H. FRANKLIN WATERS, Chief Judge.

Defendants have filed numerous objections to Magistrate Ned A. Stewart, Jr.'s Proposed Findings and Recommendations denying their motions challenging the sufficiency of the plaintiffs' consolidated complaint, under Federal Rules of Civil Procedure (FRCP) Rule 12(b)(6). These objections are before this court pursuant to 28 U.S.C. Sec. 636(b)(1).

Plaintiffs in this action are Thomas Robertson, Jr., Trustee in bankruptcy for the Farmer's Co-op of Arkansas and Oklahoma, Inc., and Bob Reves, *et al*, a class of plaintiffs composed of Co-op members, distributees of unpaid Co-op patronage dividends and holders of Co-op demand notes.

There are 36 defendants, plus 1-20 "John Does", and, cumulatively, their motions cover the field, touching all 16 causes of action, whether asserted by the Trustee or by the class. The court has determined to address these questions collectively, and to address only those motions which question whether the complaint states a cause of action. Questions of limitations, etc., will be reserved for summary judgment should the parties wish to raise them.

A. PRELIMINARY DISCUSSION

Motions under rule 12(b)(6) of the Rules of Civil Procedure must accept all facts stated by the plaintiff to be true. *Jenkins v. McKeithen*, 395 U.S. 411, 421, 89 S.Ct. 1843, 1848-49, 23 L.Ed.2d 404 (1969). The court notes this elementary point for two reasons. First, in many cases, defendants' motions took extended issue with the truth of statements in the plaintiffs' complaint. In olden days, 12(b)(6) motions were called demurrers. A demurrer which took issue with matters raised by the complaint, or which sought to enlarge the complaint by pleading additional facts, was called a "speaking demurrer". It was customary for courts to deny such pleadings because they spake. In this case, if defendants' demurrers could talk, what tales they would tell! Defendants have invited the court to peruse argumentative exhibits consisting of publications from accounting societies, affidavits from parties, depositions, interrogatories, resumes, job descriptions, statements of witnesses, and you name it. Plaintiffs have filed responses including exhibits ranging from Business Week opinion pieces, affidavits from eminent accountants, letters from their clients, legal bills, newspaper articles about Capitol Hill doings, etc. As a consequence, the file of motions, briefs, and exhibits is some two feet thick. The primary reason, therefore, for stating such an elementary point at the head of this opinion is to express some measure of the court's irritation at the flouting of Rules of Civil Procedure by counsel on both sides in this case.

In addition, the court perceives that in this case a large percentage of parties on both sides are said to be relatively unsophisticated litigants, at least in the sense

that they probably have had few contacts with the civil court system. The court desires that all parties reading this opinion be aware that in making a recital of the allegations of the plaintiffs' complaint, the court in no way indicates a belief in the statements, it rather *assumes* their truth for purposes of argument.

Conley v. Gibson 355 U.S. 41, 45, 78 S.Ct. 99, 101-02, 2 L.Ed.2d 80 (1957) established the standard this court must use in determining the validity of plaintiffs' claims, upon a defendant's Rule 12(b)(6) motion: "In appraising the sufficiency of the complaint we follow, of course, the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." This standard is, of course, quite liberal. The court is obliged to construe the complaint so as to do substantial justice. FRCP Rule 8(f). The purpose of pleading is to facilitate a proper decision on the merits. *Maty v. Grasselli Chemical Co.*, 303 U.S. 197, 58 S.Ct. 507, 82 L.Ed. 745 (1938). The Rules exist to "secure the just, speedy, and inexpensive determination of every action." FRCP, Rule 1. These are preliminary observations to a discussion to be undertaken later with respect to the sufficiency of the plaintiffs' fraud complaints. A too-strict, fine-toothed combapproach to the plaintiffs' complaint leads only to prolixity and delay. The court is not inclined to dismiss a complaint on pleading points. However, where the court is of the opinion that the complaint does not and cannot state a cause of action under state or federal law, then there is no point in passing the matter into discovery. As the saying goes, you should never try to teach a pig to sing: it

can't be done, and it annoys the pig. This opinion will therefore only concern itself with whether the various counts can possibly state causes of action against the defendants under *any* view of the complaint.

In addition to motions brought under FRCP Rule 12(b)(6), several defendants have raised serious limitations issues. To the extent that the complaint obviously sets forth matter beyond the relevant period of limitations, the court feels that the plaintiff *should* have pleaded acts or circumstances which take the matter past the bar by limitations. *Stewart Coach Indus. Inc. v. Moore,* 512 F.Supp. 879 (D.Ohio, 1981). Because this was not done, the court prefers to take these questions up on summary judgment. Local Rule 29 requires summary judgment movants to append to their motion statements of facts not disputed. The court feels that a Rule 56 motion filed conformably with local rules will best determine questions of limitations as justly, speedily and efficiently as possible. Similarly, certain "honorary" directors question their place in the lawsuit. The court is sympathetic to their argument. The complaint, however, states that they are directors, and for present purposes the court is inclined to keep them in the lawsuit until such occasion as the question can be reduced to agreed statements of fact, as *per* summary judgment. With these reservations in mind, the court will proceed to redact the plaintiffs' complaint in narrative form as background for discussing the causes of action expressed in the consolidated complaint.

B. PROCEDURAL BACKGROUND AND NARRATIVE SUMMARY OF PLAINTIFF'S COMPLAINT

On February 23, 1984, the Farmer's Co-op of Arkansas and Oklahoma, Inc., filed for bankruptcy under Chapter XI of the bankruptcy code. Nearly a year later, the Trustee filed an action on behalf of the Co-op, its members, and demand noteholders, charging individual managerial employees of the Co-op, all of the Co-op's professional advisers (*i.e.*, accountants and lawyers,) and all of the Co-op's directors during the 1974-84 period. The suit charged defendants with fraud, negligence, recklessness, contract, securities, and R.I.C.O. violations, *inter alia*, and sought restitutionary, compensatory, statutory, and punitive damages. The defendants promptly moved the court for an order dismissing the Trustee's claims on behalf of the members and demand noteholders, alleging that he lacked standing to assert such claims. *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416, 92 S.Ct. 1678, 32 L.Ed.2d 195 (1972). Bob Reves and other members and demand noteholders filed a petition to intervene, and sought permission to assert a class action against the defendants named in the trustee's complaint. The complaints of the trustee and of the intervening class were consolidated. The District Court, on September 27, 1985, approved the recommendations of the magistrate and certified the class.

In 1952, the Co-op named Jack White its general manager. One gathers that it was not a large business at the time, but that it grew to considerable size under his management – becoming one of the largest businesses in Crawford and Sebastian Counties, Arkansas. It occupies a large commercial facility in Van Buren near the Arkansas

River, and operates extensive interests throughout western Arkansas and eastern Oklahoma.

Jack White served as general manager of the Co-op until 1983. His tenure was cut short by a federal indictment and conviction for tax fraud. The grand jury in Fort Smith indicted White and the Co-op's long time auditor, Gene Kuykendall, in September, 1980. The indictment alleged that for a period of time in the mid-1970's, White engaged in a pattern of self-dealing with the Co-op, and that Kuykendall concealed his predations by juggling the books. The petit jury convicted White and Kuykendall on all counts in January, 1981. White and Kuykendall remained free on bond pending their appeal. The conviction was affirmed by the Eighth Circuit in February, 1982.

White remained as general manager of the Co-op throughout this period until he surrendered himself for a six months' term of imprisonment. The plaintiffs' complaint alleges that he still retained effective control of the Co-op even while in jail (Par. 139). Kuykendall had audited the Co-op's books until 1977, when the Fort Smith firm of Moody and Moody assumed those duties. Kuykendall remained associated with enterprises owned or managed by White, specifically a corporation known as White Flame, Inc., whose misfortunes form the core of both the trustee's and the class' causes of action. All through the period preceding the Co-op's bankruptcy, the complaint states that Jack White dominated the Co-op board, and was able to perpetrate frauds upon the Co-op either through deceit practiced upon the board or through the active collusion of board members, some of whom were business associates of White's and some of whom received low or no-interest loans from the Co-op

for investment opportunities in non-agricultural enterprises (Par. 133, 146).

The board appeared to have the highest confidence in Jack White. Subsequent to his indictment they voted to pay the legal fees and expenses incurred by White and Kuykendall and spent over $300,000.00 doing so in a losing effort. Undaunted, even after conviction, members of the board approached local news and television media claiming that White's offense was at most a technical violation of the tax laws and that no transaction detrimental to the Co-op had been shown (Par. 81). White was permitted to remain as general manager and fiduciary of the Co-op after conviction and was even given a six-month "leave of absence" to serve his sentence. (Par. 139).

Two years before the conviction, White and Edwin Dooley were involved in an enterprise called Big D & W Refining and Solvents, Inc. Each owned half the shares. Dooley was President and White was secretary of the corporation. (This company later changed its name to White Flame Fuels, Inc., and for sake of consistency, will be referred to as White Flame throughout this opinion.) White Flame decided to build a plant to produce gasahol, and began building the facility in June, 1979 (Par. 25). A few months later, White bought Dooley's shares and agreed to hold Dooley harmless for the $1.2 million they had borrowed to finance the plant. The White Flame balance sheet for 1979 was then prepared by Kuykendall, and showed a net worth of $350,000, attained by carrying the gasahol equipment and plant at their purported cost of $1.5 million. White Flame was insolvent at the time (Par. 27). Apparently, the plant and equipment were poorly designed and grossly inefficient.

White experienced great difficulty attracting capital to continue operating White Flame. Conventional lenders wouldn't touch it. The Farmers Home Administration advised him that the plant would have to produce at 90% capacity for sixty days before it would be eligible for financing. The best the plant could produce was 25% capacity. White continually solicited FmHA financing from January, 1980, until October, when he learned that his application would no longer be considered. In the meantime, White induced Co-op to lend White Flame money to operate its plant, and gave the Co-op his guaranty for low-interest, unsecured loans eventually amounting to $3.8 million. The plaintiffs charge that these loans were either completely unauthorized or were made by deceiving the board (Par. 33).

By the end of 1980, therefore, Jack White was in financial straits because of White Flame. Because he had guaranteed White Flame's debt to the Co-op, he stood to lose his entire personal fortune if the Co-op called in the loans. The complaint alleges that certain defendants conceived a plan to have the Co-op buy White Flame from White in return for a release of his nearly $4 million in personal obligations to the Co-op.

At the December 11, 1980, board meeting, the Co-op's general counsel, Carl Creekmore, announced his resignation. The following day, Creekmore filed a lawsuit for the Co-op against White. The complaint in the lawsuit was prepared by White's counsel in the criminal tax fraud case, Ball and Mourton of Fayetteville, Arkansas. Ball and Mourton, had been tax counsel to the Co-op since 1974. They had represented the Co-op in tax deficiency proceedings stemming out of the IRS investigations which

culminated in the indictment of White and Kuykendall. Perhaps as a result of that association, they became White's personal counsel in the criminal case. The complaint alleges that Ball and Mourton unethically represented the interests of both the criminal (White) and his victim (the Co-op) and ignored their fiduciary duties to the Co-op.

Shortly after Creekmore filed the complaint, Ball and Mourton mailed Creekmore White's answer and a proposed consent decree. Creekmore filed the answer and secured the chancellor's approval of the decree. The effect of the decree was to transfer White Flame to the Co-op and to release White from his guaranty on the $4 million in loans and interest owed to it. The complaint states that certain documents were altered to make it appear as though the Co-op had bought White Flame ten months earlier, in February, 1980 (Par. 43).

As a proximate result of this transaction, the Co-op relinquished an asset purportedly worth $4 million (White's guaranty) for assets worth only $500,000. These assets required further investment to become productive, and the Co-op spent $1.8 million for that purpose. The acquisition of White Flame pushed the Co-op to the point of insolvency, and disabled it from continuing in business unless it misstated the value of the White Flame assets (Par. 44).

During this time Oren Moody, of the firm of Moody & Moody, CPAs, served as the Co-op's independent auditor. He undertook to audit the Co-op's books as of December 31, 1980, and presented his report to the Co-op board in March, 1981, after White and Kuykendall had

been convicted of self-dealing and "cooking the books" in the federal criminal tax trial. The plaintiffs state that Moody's report was negligently and fraudulently misleading to the Co-op and investors, principally existing and future holders of the Co-op demand notes. Particularly, they allege that Moody reported the $4.1 million receivable from White Flame to the Co-op at full value when he had no reason to believe it was collectable; that he failed to report White Flame's $1 million loss for 1980 on the Co-op's income statement, thereby allowing the Co-op to show a profit when it had in fact lost substantial sums; and that Moody failed to "go behind" White Flame's 1980 audit, which was fraudulently prepared by Kuykendall, thereby rendering his own opinion an instrument of fraud against the Co-op, its members and investors.

Plaintiffs charge that Kuykendall's audit of White Flame (which was incorporated into the Co-op audit,) falsely reported the net worth of White Flame's assets as $4 million when they should have evaluated them at $500,000. The plaintiffs also claim that Kuykendall fraudulently reported that White Flame had lost only $80,000 during the first year, when in truth it had lost over a million dollars. These fraudulent audit findings were reported as true in the Moody audit, and materially misled Co-op members and investors, due either to Moody's negligence or fraudulent connivance.

The plaintiffs further allege that the Moody audit misled members and investors by reporting only 20% of the outstanding Co-op demand notes as current liabilities. The demand note program started in 1959. The Co-op solicited individuals to invest money, and in return

the Co-op would give them promissory notes, payable on demand, carrying an interest rate higher than that available from local banks and savings institutions. The higher interest made the opportunity attractive to investors; the lack of F.D.I.C.-type insurance made it perhaps less attractive. One gathers from the complaint that individuals would invest in such a program only if the enterprise looked safe from a business standpoint. In this connection, financial reports and audits were important influences in an individual's decision to invest his money in Co-op notes. One infers that an accurate accounting of current assets and liabilities would be important, since the Co-op's ability to promptly retire current liabilities depended on the depth of its current assets. Reporting the demand notes as 80% long-term liabilities painted a roseate picture of the Co-op's ability to absorb a "run" by investors in its savings program.

Until 1964, the Co-op had, in fact, reported the demand notes as 100% current liabilities. Beginning in 1965, however, Co-op statements accounted the notes as one-third current, two-thirds long term. In 1973, this was changed to one-fifth. White and Kuykendall initiated this misstatement, and in 1977, when Moody became auditor, he continued it. When Arthur Young & Co. became auditor in 1981, it corrected the misstatement and began reporting the demand notes as 100% current liabilities again. But for the 1980 audit, Moody reported the Co-op's current liabilities at $11 million against current assets of $13 million. The complaint suggests that a true picture would have shown the Co-op backing up to $18 million in current liabilities with $13 million in current assets.

Arthur Young took over the Co-op's audit for the year ending December 31, 1981. The plaintiff trustee and investors claim that Arthur Young materially misled the Co-op and its members/noteholders by inflating the value of gasahol assets owned by White Flame. The books reported those assets at a value exceeding $3 million, whereas in fact they were worth less than $500,000. Arthur Young's performance is termed negligent or fraudulent for not getting an appraisal of White Flame's properties. Instead, they arbitrarily decided to treat the gasohol plant as having been owned by the Co-op from the start of construction even though they knew that this was not the case (Par. 60). The plaintiff alleges that Arthur Young considered requiring the Co-op to write the White Flame assets down to their net realizable value, and in the absence of compliance, to issue an adverse opinion. Arthur Young's auditors are charged with knowing that White and Kuykendall had deliberately cooked White Flame's books to make it appear that items properly chargeable to expense were added to the capital asset account. For these reasons and others, the plaintiffs allege negligence, gross negligence and fraud against Arthur Young.

Arthur Young gave the Co-op an unqualified opinion in 1981 and 1982, and presented the same to the Co-op's annual meetings in March 1982, and 1983. The actual opinions footnoted a reservation that there was "some doubt as to the recoverability of the Co-op's investment in White Flame", an investment which, by the time of the March, 1983, meeting, had grown to over $7 million. The Co-op, with the knowledge and participation of Arthur Young, issued a "condensed" version of its financial

reports to its members and noteholders. The "condensed" reports, which were known to Arthur Young and the management clique of the Co-op to be materially misleading, contained no reservations concerning the recoverability of the White Flame investment. Management circulated a report to the members and to the public that the Co-op was financially sound throughout 1981 and 1982, when it was in fact insolvent.

For some time, the Arkansas Securities Department had been concerned about the Co-op's demand note investment program. As early as the mid-70's, it had written the Co-op and demanded that the notes be registered as securities. In March, 1974, the department demanded that White disseminate accurate financial information to current and prospective members and investors. White misled the department, saying that the Co-op did so, when in fact the reports it circulated were condensed reports such as Moody's, which in themselves were misleading because they contained no explanatory notes.

In May of 1983, the Securities Department demanded that the Co-op cease accepting further investments in demand notes until appropriate disclosures were made. Attorney Morril Harriman counseled the Co-op's general manager (then Fred Howard) to sign an agreement to comply, and then counseled him to ignore the agreement and to accept notes. It is alleged that, if access to demand note capital had been denied the Co-op, it would have folded then there. Harriman represented to the Securities Department that the Co-op was solvent, when, in fact, it was not.

In October, 1983, the department permitted the Co-op to issue demand notes and "re-investment certificates" on the condition that persons be issued an offering statement at the time of initial investment or monthly reinvestment of interest. The new general manager, Eddie Joe Smith, knowingly permitted members and investors to invest and reinvest their money in the Co-op without showing them the offering statement. Had he shown them the offering statement (which was so worded as to make it unlikely that any person would choose to invest), the disclosure would have caused a run on the Co-op which it could not have absorbed.

A few months later, the Co-op declared itself bankrupt and entered re-organization proceedings.

The defendants in this action, thirty-six by present count, array themselves into three basic groups. The first group may be termed the management group, and consists of Jack White, Gene Kuykendall, Comptroller Kirit Goradia, General Manager Eddie Joe Smith, as well as enterprises owned or controlled by White, such as J.E.W., Inc., White Flame Fuels, Inc., and Valley Feeds. Basically speaking, members of this group are said to have directly assisted White in looting assets of the Co-op by fraudulently making book entries and concealing White's self-dealing. In this connection, the complaint speaks of Kuykendall and Goradia primarily. White's three corporations are alleged to have looted Co-op assets. Eddie Joe Smith is alleged to have conspired with White (Par. 15) and to have fraudulently prolonged the life of the Co-op for the purpose of attracting investments in the demand

note program, despite a knowledge of the Co-op's insolvency, and the certain failure of any investment made in it.

The second group of defendants may be referred to as the professional group, and consists of accountants with Moody & Moody, and Arthur Young and Co. A number of attorneys are also included among this group, specifically E.J. Ball and Ken Mourton, and through them the firm of Ball, Mourton & Adams, and Carl Creekmore and Morril Harriman, and through them Creekmore and Harriman. All are said to have conspired with Jack White, except perhaps Steven Adams, who practices with Ball & Mourton (Par. 15).

The third group consists of the Co-op directors. These number twenty-one parties, two of whom are dead. The complaint suggests that some directors were culpable of fraud and directly connived with White; and that the remainder were negligent, grossly negligent and reckless in their stewardship.

C. PLAINTIFFS' CAUSES OF ACTION

COUNT I: RETURN OF PROFESSIONAL FEES PAID TO LAWYERS' ACCOUNTANTS

Count I seeks return of legal fees and expert witness fees incurred in the defense of White and Kuykendall, paid by the Co-op to the firm of Ball and Mourton, attorneys at law, and Arthur Young & Co., CPA's. On September 4, 1980, the federal grand jury indicted Jack White and Gene Kuykendall. The gist of the indictment was that the Co-op's tax return had been falsified by

mislabelling certain payments to and from the Co-op as patronage income and dividends. The indictment charged that White engaged in a course of self-dealing with the Co-op, and that White and Kuykendall had conspired to conceal from the IRS the true nature of White's transactions with the Co-op. Specifically, the government charged that by manipulating the books and records of the Co-op, White and Kuykendall masked the true nature of an Industrial Development Bond issue, and disguised payments of taxable compensation to White as tax-exempt interest.

On September 8, 1980, the Co-op's Board of Directors met and unanimously passed a resolution expressing its confidence in White and Kuykendall. Later, on December 11, 1980, the Co-op board, in a regular meeting, voted to pay White's and Kuykendall's legal expenses. The criminal trial commenced January 5, 1981, and the jury returned a verdict of guilty on January 23. The defendants appealed their conviction to the court of appeals, which heard arguments on December 11, 1981, and dismissed the appeal on February 26, 1982. The opinion of the Eighth Circuit stated: "The record clearly demonstrates that White and Kuykendall manipulated the Co-op's finances to serve their own personal ends, and that they distorted the Co-op's records of receipts subject to corporate income tax." *United States v. White*, 671 F.2d 1126, 1134 (8th Cir. 1982). The opinion relates, *inter alia*, that the Co-op paid interest to White in the amount of $149,600 in 1975 and 1976, and incurred a $50,000 fee to underwriters, as a result of a transaction in which the Co-op lent White $1,500,000, interest-free, in order to buy an

equivalent amount of its bonds to finance construction of new facilities.

Plaintiffs charge that it was wrong for Ball and Mourton, the defense attorneys, to take legal fees from the Co-op because the firm also represented the Co-op on tax matters, and therefore owed it a fiduciary duty to protect its interests. The complaint charges that Ball and Mourton knew or should have discovered that White and Kuykendall had impermissibly acquired Co-op assets, that defendants' course of conduct was self-interested, and that the Co-op, as victim of their predations, should not be expected to fund the defense of the wrongdoers. The White and Kuykendall defense team hired accountants with Russell Brown & Co. (later Arthur Young) to give expert testimony for the defense during the criminal trial. The Arthur Young accountants are charged with knowledge of White's and Kuykendall's self-dealing activities, making their receipt of fees from the Co-op wrongful.

In sum, the attorneys and accountants are charged with knowing that White's and Kuykendall's activities in no way benefited the Co-op, and were not intended to, and that such actions could not constitute, on the part of White and Kuykendall, a good faith discharge of their duties to the corporate entity. The complaint in Count I charges that White and Kuykendall unlawfully obtained $300,000 of Co-op funds for their defense. The complaint seeks actual and punitive damages for the Co-op and the class from White and Kuykendall on the theory that the expense of defense was personal to them and not one properly payable by the Co-op; from defendants Creekmore and Harriman, the Co-op's general counsel, on the theory and they should have advised the Board not to

approve this outlay, such failure being negligent or fraudulent; from the directors, on the theory that they negligently or fraudulently approved the disbursement of Co-op funds; and from the defense attorneys and accountants, on the theory that they were *particeps* in the receipt of Co-op funds on behalf of White and Kuykendall, and thereby breached their own personal fiduciary duties (at least in the case of Ball & Mourton), or assisted White in violating his own fiduciary responsibilities.

The lawsuit purports to seek recovery under this court on behalf of both the Co-op and class. At least insofar as this count is pressed by the class, it must be dismissed for lack of standing. The right of action against officers and directors to redress wrongs to the corporation resides in the corporation and, except as statutes might otherwise provide, the right is the exclusive property of the corporation. *Red Bud Realty Co. v. South,* 153 Ark. 380, 396, 241 S.W. 21 (1922). A wrong done to a corporation is one done to the entity and not to the shareholders distributively. *Jones v. Foster,* 70 F.2d 200, 205 (4th Cir. 1934), *cert. denied,* 293 U.S. 558, 55 S.Ct. 70, 79 L.Ed. 659 (1935). Stockholders may bring derivative suits, of course, but such suits are equitable in nature even if premised on legal grounds. *Taylor v. Terry,* 279 Ark. 97, 649 S.W.2d 392 (1983). As vehicles of equity, punitive damages are not available. Jury trials, also, are not available in equity for the claims of shareholders. To include class claims in this count will entail only confusion. Generally, therefore, where the corporate entity has already sued, and there is no claim that the interest of the shareholders was not adequately represented by the corporation, it is error to allow a separate action brought by

shareholders to proceed. *See, e.g., Vanderboom v. Sexton,* 460 F.2d 362 (8th Cir. 1972).

The class argues that Arkansas departs from the rule disallowing shareholders to sue in their own name for damages suffered by the corporation, *citing inter alia, Henderson v. Rounds and Porter Lumber Co.*, 99 F.Supp. 376 (W.D.Ark.1951); *In re Ozark Restaurant Supply Co., Inc.*, 41 B.R. 476 (Bankr. W.D.Ark.1984); *Sternberg v. Blaine*, 179 Ark. 448, 17 S.W.2d 286 (1929); *Bank of Commerce v. Goolsby*, 129 Ark. 416, 196 S.W. 803 (1917); and *Bank of Des Arc v. Moody*, 110 Ark. 39, 161 S.W. 134 (1913). These cases are distinguishable. *Henderson* and *Ozark Restaurant* were creditors' actions against parties who had abused the corporate form to defraud trade creditors. Both cases deal with controlled or subsidiary organizations which were forced to sell their wares to the parent at artificially low prices, by which practice the subsidiary became insolvent. The induced insolvency worked a fraud on those suppliers who extended credit to the subsidiary. In *Henderson* the creditor himself, and in *Ozark Restaurant*, the bankruptcy Trustee, were permitted to undo the frauds perpetrated through the subsidiary. These authorities do not overrule *Red Bud Realty v. South, supra*. They are distinguishable. They do not suggest that a shareholder in a corporation may directly sue third parties who supply defective goods or services to the corporation. Such a holding would introduce chaos and mischief. Suppliers of defective goods and services could conspire to have owners of a single share file actions against them in equity court to avoid juries and penalties.

The remaining three authorities cited by plaintiffs, *Sternberg v. Blaine, Bank of Commerce v. Goolsby,* and *Bank*

of Des Arc v. Moody, supra, are bank failure cases from early in the century which held that bank directors were liable to shareholders and depositors for negligent supervision ending in insolvency. None of them concerned a matter such as the one here in suit; that is, a shareholder's personal right to sue a third party who allegedly owes a corporation some money or who provided faulty goods or services to the entity. The court is convinced that such an action by a shareholder is purely derivative. As a derivative action, it cannot proceed where the corporation or its trustee have already filed the claim. The class' cause of action under Count I is hereby dismissed.

In further support of its decision, the court notes that in 1965, the Arkansas General Assembly passed the Model Business Corporation Act. The state's organic corporation law, to the extent that it once might have allowed shareholders to sue third parties, now provides that such actions proceed as derivative suits. Ark.Stat. Ann. Sec. 64-223 (1980 Repl.). While there may be shareholder actions which are personal in nature, rather than derivative, such is not the case in this instance. As Henn, *Law of Corporations,* 2d Ed H.B., Sec. 360 at 757 (1970) says:

> "No simple and foolproof method exists whereby a derivative action may be distinguished from a shareholder's direct or individual action. But generally speaking, the breach of the shareholder's membership contract gives rise to a direct or individual action while a wrong to the incorporated group as a whole (*i.e.,* breach of some duty to the corporation) is the basis for a derivative action."

If the cause of action expressed in this count belongs to anyone, it belongs to the trustee. Defendants attack the trustee's complaint on the grounds that it states no cause of action, and that even if, *arguendo*, a claim is stated, it is barred by the three year statute of limitations for fraud. Without going into detail, the court is convinced that defendants' arguments are meritless.

There is little doubt that a corporation may pay attorney's fees for the criminal defense of directors and officers. When the corporation agrees to pay those fees in advance, the law requires the officer or director so benefitted to agree to pay the money back in the event that his actions were not found to have been in good faith. Ark.Stat.Ann. Sec. 64-309(E). It does not appear that this was done. Given the tenor of the Eighth Circuit's opinion that White's and Kuykendall's acts were directed towards "personal ends," *United States v. White*, 671 F.2d at 1134, a reasonable director would have concluded that repayment by the defendants was in order. That this course was not pursued gives the trustee the right to proceed against the directors under Arkansas law. Furthermore, the third parties involved in this case knew or should have known, under the pleadings, that they were accepting money from the Co-op, to defend Co-op fiduciaries, for acts which, if proven, constituted a serious breach of fiduciary duties. In *Raines v. Toney*, 228 Ark. 1170, 313 S.W.2d 802 (1958), the court held that persons who assist a fiduciary in the breach of his obligations are liable to the persons or entities so damaged.

The limitations arguments of the defendant lawyers and accountants have been noted, but are not now decided since the question when the limitations period

actually began to run against the Co-op may be one for the jury, in the absence of undisputed facts. *See, e.g., Vanderbloom v. Sexton,* 460 F.2d 362, 364 (8th Cir. 1972) (semble). If facts are undisputed, as well as inferences to be drawn therefrom, we may take this up in summary judgment form.

Defendants' motions to dismiss the trustee's claim are hereby overruled.

COUNT II: FRAUD AND VIOLATIONS OF FIDUCIARY DUTY RELATING TO THE GASOHOL PLANT

Plaintiffs' second cause of action attacks the transaction by which White Flame Fuels was transferred to the Co-op. The complaint charges Jack White and his related enterprises with fraud, and also states claims against Kuykendall and his partners, the Co-op's directors, Ball and Mourton, Goradia, Creekmore and Harriman. As previously related, the complaint charges that White Flame, whose asset values were inflated eight-fold by Kuykendall, was passed to the Co-op in return for the cancellation of $4 million of indebtedness owed by it and White. The complaint includes an allegation that attorneys and White, along with attorneys Carl Creekmore, and the firm of Ball & Mourton, conspired to commit a fraud on the Crawford County Chancery Court as an element of their plan. As a result of these actions the complaint seeks damages "for all losses sustained by the Co-op". (Consolidated Complaint, Count II, p. 23).

For reasons discussed in the court's opinion with respect to the class's standing to bring a complaint

against third parties, *supra,* the court dismisses that part of Count II which seeks damages for the class.

Defendants vigorously argue that the entire complaint charging fraud in Count II should be dismissed for failure to plead reliance and for failure to plead specific facts under Rule 9(b). The court conceives this as a very considerable grievance for certain defendants, who claim not to know what they are charged to have misrepresented, and which persons, if any, relied to their detriment upon statements made by them.

It is a matter of some debate in the courts whether Rule 9(b), which requires that fraud be specifically pleaded, is relaxed by Rule 8, which demands that only a short statement of the claim be required: or whether detailed narrative pleadings are required in fraud cases notwithstanding the notice pleading ordinarily required under Federal Rules. In a wide-spread case of alleged fraud, such as this one, spanning five years and involving thousands of parties, as many as 57 of whom are defendants, a specifically pleaded complaint could run into the hundreds and hundreds of pages. There have been any number of pained remarks by defense counsel concerning the length of this "abbreviated" complaint, so as to persuade the court that, if the plaintiffs had chosen to plead with that specificity demanded by the defendants, the court should now be having to pass on motions to strike. *E.g. Iafrate v. Compagnie Generale Transatlantique,* 12 FRD 71 (S.D.N.Y. 1951).

The court therefore feels that a balance needs to be struck in fraud cases of this kind. The court believes that to the extent that a fraud complaint identifies with a fair

amount of particularity the transactions being questioned, the dates upon which they occurred, and the principal actors involved, the pleadings should pass muster. The court has little difficulty following the thread of plaintiffs' complaints. If it were required to put itself in the position of a party summoned to defend this action, the court believes that it would be able to identify the relevant issues and prepare an apt answer and defense. To require much more would be wasteful, and, as this case proves, dilatory.

It is probably not even advisable that a fraud plaintiff plead with greater particularity than was done here. Plaintiffs have the heavy burden of proving fraud by clear and convincing evidence. *Bradley v. Southern Farm Bureau Casualty Co.*, 392 F.Supp. 478 (E.D.Ark.1975). In Arkansas, that standard is deemed satisfied when the proponent produces " . . . evidence by a credible witness whose memory of facts about which he testifies is distinct and whose narration of details thereof is exact and in due order and whose testimony is so clear, direct, weighty, and convincing as to enable the factfinder to come to a clear conviction, without hesitancy, of the truth of the facts related . . . " *Kelly v. Kelly*, 264 Ark. 865, 575 S.W.2d 672 (1979).

A defendant's credibility is critical in an action based on fraud. If the plaintiff were required to disclose in his first pleading every circumstance grounding his belief that he has been defrauded, a wrongdoer would be apprised of the identity of plaintiff's sources and the extent to which he has secured documentation for his belief. Such a wrongdoer would be given an opportunity

in advance of oral discovery to begin fashioning testimony to explain apparent contradictions. Counsel experienced in fraud litigation well know the vital importance of committing defendants to completely impeachable accounts of their actions and motives. If the defendant is completely informed of the materials in his opponent's possession, the best efforts of counsel to ensnare him in a web of his own deceits will be for naught.

In saying this, the court does not presume that any fraud has been practiced by any of these defendants. It bears notice, however, that the innocent fraud defendant stands to gain nothing more than a general litigation advantage from a requirement that the plaintiff detail every circumstance giving rise to his belief that he has been defrauded. The truly injured plaintiff, on the other hand, stands to forfeit whatever chance of success he holds against the heavy odds laid down by the clear and convincing standard of proof in his case. Pleading rules should not be read to demand a level of particularity that only makes a complaint prolix, at great cost to the plaintiff, and with no special benefit running toward the honest defendant, whom Rule 9(f) is designed to aid.

For the reasons indicated above, the court believes that the complaint sufficiently alleges both fraud and reliance (Consolidated Complaint, Para. 68). The court would note plaintiffs' suggestion that reliance may be presumed in cases such as this one. This may well be the law in other jurisdictions. *Zatkin v. Primuth,* 551 F.Supp. 39 (S.D.Cal.1982). But in Arkansas, fraud is never presumed. *Donovan Construction Co. v. Woolsey,* 358 F.Supp. 375 (W.D.Ark.1973). Whether reliance *as an element* of fraud may be presumed as plaintiffs suggest is an open

question, unnecessary to be resolved since the court believes for present purposes it has been sufficiently alleged.

The court notes that the complaint does not, for example, specifically state that Moody's determination to treat demand note funds as long-term liabilities either induced a party to buy the notes, or persuaded him to forebear from selling them when a prudent investor would have done so were he fully advised of the facts. If an auditor owes fiduciary duties to a corporation [and the court does not now decide that they do, *but see, Investors Funding Corp. of N.Y. Sec. Lit.*, 523 F.Supp. 533, 542, n. 4 (S.D.N.Y.1980)] then actionable fraud would exist not only as to positive deceit, but also where the fiduciary failed to disclose important facts, a situation where reliance is *inferred* rather than proved. Furthermore, reckless conduct freely substitutes as sufficient evidence of fraud in fiduciary contexts. Moody's reckless failure to inform the Co-op that the entity was nearly insolvent, and lacked sufficient current assets to retire the demand notes when "due", might very well make out a submissible case of fraud under such a theory.

The complaint is therefore dismissed as to the class and sustained as to the Co-op.

COUNT III: SECURITIES FRAUD IN TRANSFERRING WHITE FLAME TO THE CO-OP

Count III charges White, his related enterprises, Kuykendall, Co-op directors, Ball and Mourton, Goradia, Creekmore, and Harriman with securities fraud in transferring White Flame stock to the Co-op. The complaint

alleges that the transaction violated the Securities Exchange Act of 1934 and the Arkansas securities fraud statute. The complaint states a cause of action under both the federal and state law. However, inasmuch as the Co-op, and the Co-op alone was the "buyer", the complaint does not state a cause of action on behalf of the members and patronage dividend holders.

COUNT IV: WRONGFULLY PROLONGING OPERATION OF THE CO-OP AND MISLEADING GOVERNMENT AUTHORITIES

Count IV seeks damages for the Co-op and the class against essentially all of the defendants for negligence and fraud in prolonging the existence of the Co-op after insolvency. (Para. 53, Consolidated Complaint). *See, Schacht v. Brown*, 711 F.2d 1343 (7th Cir.), *cert. denied*, 464 U.S. 1002, 104 S.Ct. 509, 78 L.Ed.2d 698 (1983). This count of the consolidated complaint may proceed on behalf of the Co-op and the class because even though the pleading specifies a common core of negligent/fraudulent acts, the damages sustained by the class are different from those alleged to have been suffered by the Co-op. The operation of a corporation beyond the point of its insolvency works a fraud upon creditors and investors, at least to the extent that they have been misinformed as to the true status of the corporation's affairs. The consolidated complaint (at Para. 67) alleges, for example, that the Arthur Young defendant knew that class members, largely elderly unsophisticated parties, were investing millions of dollars in the Co-op on the strength of audits by Arthur Young which had been "condensed" to a point where they failed to show that which the Arthur Young partners knew to be

the case: that the company faced a "high probability of bankruptcy." Had the investors been correctly informed, they would either have refrained from transferring their savings to the uninsured Co-op, or they would have taken steps to withdraw their moneys from the corporation. As a result, the class is said to have lost the value of investments made after February 14, 1980 (Consolidated Complaint, Para. 107).

The Co-op, on the other hand, is said to have lost moneys by virtue of the fact that the artificial prolongation of its existence disabled officers, directors, and/or members from taking action to redress wrongs done to it; that it continued to incur liabilities beyond a time when it could have managed to absorb them, deepening the damages to its fisc; and that it became a helpless victim of further looting throughout its insolvency, whereas if it had been in receivership, its assets would have been saved rather than squandered. (Consolidated Complaint, Para. 106). One thinks, in this connection, of the $1.8 million spent by the Co-op to operate the defunct White Flame plaint after it was officially transferred to the Co-op by White. [Consolidated Complaint, Para. 44(b)].

The plaintiffs, then, were injured *severally* by the acts of the defendants in prolonging the existence of the corporation. This is not a case where the Co-op, principally, was injured, and therefore its members and shareholders were affected. Instead, the investors were injured by being induced to become members of the "class". Not to put too fine a point on it, the investors theoretically have a cause of action *against* the Co-op for issuing demand notes to them. The Co-op has no power to sue for damages it caused. The essential distinction between those

damages sought in Counts I, II, and III, where the court has disallowed the class from proceeding, and those sought in this count, where the class may present its complaint, is that in the former instance, all damages directly affected the Co-op, and no such direct effect visited the class; whereas in the latter instance, class members have suffered damages unique to themselves, losses which the Trustee could not claim because he represents an entity *actually adverse* to the class insofar as their claim in concerned.

The consolidated complaint alleges that the negligence of certain accountants and lawyers damaged the class by presenting an image of financial salubrity, when in fact the Co-op was practically bankrupt if not actually insolvent. At issue, then, is the liability of professional advisers to the investing public for negligent misrepresentations presented in financial reports, audits, etc. As a general rule, an accountant is liable to persons not in privity with him only for fraudulent misrepresentations, not for negligent ones. *Ultramares Corp. v. Touche,* 255 N.Y. 170, 174 N.E. 441 (1931). This decision is somewhat of an anomaly: it was written at a time when the "citadel of privity" had been breached on nearly all sides, chiefly because of the work of Justice Cardozo, who authored the *Ultramares* "exception." This limitation on general negligence liability has survived numerous subsequent challenges, although recently third parties have enjoyed a limited measure of success. *See, e.g., Zatkin v. Primuth,* 551 F.Supp. 39 (S.D.Cal.1973); *Ingram Industries v. Nowicki,* 527 F.Supp. 683 (E.D.Ky.1981). "Academic" opinion, *viz.* Restatement 2d Torts, Sec. 552, is hostile to the *Ultramares* limitation. It is said in short that the "better" or "more

progressive" rule of law is to abandon the privity defense in cases where a professional has negligently advised his client, resulting in damages to third parties.

This court does not conceive its duty to be to apply so-called "more modern" rules of law in diversity cases; rather, it believes that it should apply the rule which Arkansas courts would most probably use to determine a conflict. First, the American Law Institute, which sponsors the Restatement 2d Torts, is a learned body, but not a governing one. It is unaccountable to the political process. There was sparse curial support for the Institute's determination that liability should attach even in the absence of privity. In fact, there was none. This court hesitates to follow the lead of plaintiffs' counsel who argue that duties be created to favor remote parties because for example, of the "availaibility of insurance" to cover the risk. It seems to the court that this make-weight argument really stands the entire question on its head. The standard of behavior ultimately being enforced in such a case is a "duty to buy insurance". Given the currently and widely expressed concerns among Arkansas legislators about the availability and cost of business insurance (*see*, Arkansas Gazette, March 17, 1986, p. 3) and their growing determination to act legislatively in this very area, either by limiting the kinds of claims that might be presented or by adjusting the premiums which might be charged, this court feels that it is most inappropriate for it to be creating "new torts" at this time, and declines to pronounce liability in the absence of strong signals from our state courts that they would do so.

Second, such "stong signals" are absent in this instance. In fact, to the extent that such a case was ever presented in Arkansas, a federal court sitting in diversity determined *sub silentio* that negligence was not the appropriate standard of behavior to measure the duty of care running from an accountant to a third party relying on his audit. *Donovan Construction Co. v. Woolsey*, 358 F.Supp. 375, 383 (W.D.Ark.1973). In fact, it is a general rule of Arkansas contract law, (except in sales of goods), that consequential damages for faulty performance are strictly limited to those which necessarily flow from the breach, or which were tacitly agreed-to by the breaching party. Note, "Tacit Agreement Rule Reaffirmed in Contract Cases in Arkansas," 32 Ark.L.Rev.139 (1978). This rule is not direct or compelling authority for the court's position on this issue. Rather, the rule obliquely supports the court's determination in this way: the contractual relation ship is initially consensual, and the Arkansas courts conceive that the relationship maintains its consensual character throughout, even to the point of holding that a breaching party must be found to have "assented to such a liability" before he might be charged with consequential damages for his breach. *See, Hooks Smelting Co. v. Planters Compress Co.*, 72 Ark. 275, 286, 79 S.W. 1052, 1086 (1904). As the Arkansas Law Review note suggests, Arkansas has held to this minority position even in the face of its decline elsewhere in the country. This court would find it hard to believe that Arkansas would broaden tort liability to innumerable third parties arising out of a contractual relationship, while it retains a strict limitation *vis a vis* the extent and kind of contractual remedies available to the parties in privity.

Finally, even if the court were inclined to allow third parties relief for negligent misrepresentations, it would not do so in this case. Those jurisdictions allowing third parties relief in cases such as these have done so where small numbers of plaintiffs comprise the class. The court understands that there are upwards of 23,000 persons in the plaintiff class, several thousand of whom are holders of demand notes. This class is simply too large even for the more modern theory of liability suggested by Restatement 2d Torts Sec. 552.

This means, in sum, that that part of the class' complaint charging negligence will be dismissed. The class may pursue its action grounded in fraud, or such gross negligence as amounts to fraud. The Co-op may ground its action in negligence or fraud, since it enjoys privity of contract with its professional advisers.

COUNT V: BREACH OF CONTRACT BY ACCOUNTANTS

The motions to dismiss filed by all lawyers and accountants ask the court to find that Arkansas law holds that no cause of action may be maintained against them for breach of contract, where the gist of the complaint is that the defendant badly performed his contractual duties. The defendants insist that such a complaint sounds exclusively in tort.

The considerable pleading and briefing on this point impels the court to conclude that this is no mere academic point. The court suspects that plaintiffs fear that if

they are forced into a cause of action sounding in negligence, they will face defenses, i.e., contributory negligence, not ordinarily available to all action on a contract. Additionally, certain facts clustering around the general rubric of fraud and deceit require the plaintiff to plead and prove that he relied on the misrepresentation. Of course, if the plaintiff has bargained and won a contractual promise that certain representations are true, then the issue of reliance falls from the case, with exceptions not relevant for this discussion.

If indeed that is an accurate statement of plaintiffs' fears (and defendants' hopes) then both may underestimate the flexibility of tort law to deal with the very special problems of negligent performance within the consensual environment of the professional relationship. Contributory negligence, for example, is commonly invoked to reduce or bar a negligent plaintiff's recovery in a traffic mishap. In the case of an audit which fails to disclose embezzlement by an employee, it is superficially appealing to suggest that the employer may be principally at fault for his losses for having failed on his own to detect the dishonesty, or in having hired an untrustworthy clerk in the first place. Yet, courts dealing with this problem have had little difficulty penetrating such an argument. *See, e.g., Lincoln Grain, Inc. v. Coopers & Lybrand,* 216 Neb. 433, 345 N.W.2d 300 (1984). Interestingly, the resolution reached by *Lincoln Grain* – that the contributory negligence of the audited client is a defense only where it has contributed to the accountant's failure to perform the contract – bears strong resemblance to the contract doctrine that one is not responsible for his failure

to perform if he was frustrated in doing so by the plaintiff.

This court cannot forecast what problems may arise from its decision on this question. Understandably, therefore, the court is loathe to make "outcome determinative" decisions on the basis of the pleadings. Nevertheless, if the law of Arkansas does not allow an action to proceed in contract against a lawyer or accountant charged with misfeasance in the course of his services, then this court would be remiss in not acting promptly on the motion. The estate and the defendants would squander valuable discovery time and resources on contract issues which may not properly be submissible to a jury. Given the staggering legal fees generated by this action, it is also uneconomic to invite later motions for summary judgment if, indeed, *no* set of facts can ever be developed which would permit an issue to be given to a jury under a set of instructions embodying contract theories.

Defendants claim, and indeed it appears, that the complaint recites that the accountants performed their services *badly,* not that they simply failed to perform them at all. Furthermore, the contracts between the auditors and the Co-op do not appear to contain any special engagements beyond the promise to audit the books and prepare the tax returns. By "special engagements" we are referring, for example, to a promise to perform the services within a particular time. If such a special promise were present, and such a promise were not part and parcel of a general duty to use reasonable care in the rendition of professional services, then an entirely different question would be presented concerning the applicability of tort on contract law. *See, e.g., L.B. Laboratories,*

Inc. v. Mitchell, 39 Cal.2d 56, 244 P.2d 385 (1952). Such a case does not appear on the state of the pleadings, and instead we are brought again to the question whether a professional's failure to observe a given standard of care in his services may be heard in contract.

The plaintiffs have cited five Arkansas cases for the proposition that one may sue an accountant or lawyer, in tort or contract, for the negligent performance of the duties: *Dorr v. Fike,* 177 Ark. 907, 9 S.W.2d 318 (1928); *Derby v. Blankenship,* 217 Ark. 272, 230 S.W.2d 481 (1950); *Midwest Mutual Ins. Co. v. Arkansas National Co.,* 260 Ark. 352, 538 S.W.2d 574 (1976); *Lawrence v. Francis,* 223 Ark. 584, 267 S.W.2d 306 (1954); *Rhine v. Haley,* 238 Ark. 72, 378 S.W.2d 655 (1964); and *Red Lobster Inns, Inc. v. Lawyers Title Ins. Corp.,* 492 F.Supp. 933 (E.D.Ark. 1980), *aff'd in part and rev'd other grounds,* 656 F.2d 381 (8th Cir.1981). The first case, *Dorr v. Fike, supra,* simply has no bearing on the matter at all. Its only relevance to the discussion is a mention in passing that a physician impliedly contracts that he will treat a patient with due care. It does not purport to answer whether a concurrent remedy for breach of that duty sounds in contract.

In citing *Derby v. Blankenship, supra,* plaintiffs have chosen an eminent authority (Justice Leflar) but the wrong case. In that opinion, an insurance agent promised to insure his client against liability imposed by the Worker's Compensation laws, and failed to do so. The facts suggested that the client told the agent that he did not want to start his sawmill operation until the insurance was placed, and gave him a $262.50 check that day for a binder. Two to three weeks after this took place, a worker was injured, and the employee took action against

his insurance agent to recover the money owed to the worker. There is some doubt, due to the fact that consequential damages were awarded for the breach whether this action truly sounded in contract, *see,* discussion of "tacit agreement" rule *supra,* at Count 4, and *infra.* That is, the damages recovered by the employee were not such as are in Arkansas ordinarily recoverable for breach of contract.

Be that as it may, the opinion appears to read as though the action were maintained in contract. This presents no problem, though, because the defendant did *not* perform his promise; that is, the essence of the action lay in defendant's utter failure to perform. As previously indicated, and as will later be developed, the failure to perform a promise implied in a professional relationship sounds in contract, rather than in tort. Finally, the court questions the applicability of the law regulating commercial relationships between a customer and his insurance agent to a situation involving the rendition of professional services.

To the same effect as *Derby* are *Midwest Mutual Ins. Co. v. Arkansas National Co.,* 260 Ark. 352, 538 S.W.2d 574 (1976); and *Lawrence v. Francis,* 223 Ark. 584, 267 S.W.2d 306 (1954), except that in *Midwest Mutual, supra,* the parties stipulated that the action was one in tort. That itself made any discussion of contract theories superfluous, except insofar as a discussion of contract law is inevitable whenever tortious misfeasance upsets an initially consensual relationship.

In *Rhine v. Haley, supra,* both nonfeasance and misfeasance appeared in one case, under two separate engagements. Mrs. Haley hired lawyer Rhine to protect her

interests in a divorce case against Dr. Haley, who, at the time the action against her attorney commenced, lived in parts unknown with his second wife. Mrs. Haley charged that Rhine was initially negligent in failing to provide security for her debts under a property settlement agreement. When the doctor departed, she held only his I.O.U. She further charged that after the decree was entered and before the doctor left, she engaged Rhine to collect her debts from Dr. Haley, and that Rhine did nothing. This breached the contract by non-performance. This court does not suggest that *all* the confusion wrought by *Rhine v. Haley* stems from this circumstance, but certainly some of it does. The impressive aspect of *Rhine* is that even where both misfeasance and nonfeasance in the context of two different professional engagements are alleged, the Supreme Court treated them not as sounding either in tort or contract, but in tort alone! This is the impact both of the award of tort damages in the case, which was affirmed *sub silentio,* and of the opinion's statement, 238 Ark. at 85, 378 S.W.2d 655, that "Although [Mrs. Haley's] claim against [Dr. Haley] was on contract, her claim against [lawyer Rhine] was in tort, on the theory that [he] was guilty of negligence." This case is particularly slim authority for the proposition that one may sue his accountant either in tort or contract for misfeasance; indeed, the case strongly suggests that no contract action is allowed, without, of course, so holding.

Finally, the plaintiff suggests that *dicta* in *Red Lobster Inns v. Lawyers Title Ins. Corp., supra,* supports its argument that a cause of action in contract may lie against a negligent professional. One familiar with

Arkansas law may strongly infer that plaintiff Red Lobster urged the court to allow its action to proceed in tort, whereas defendant Lawyers Title wanted the action to be heard in contract. By way of background, Red Lobster contracted with Lawyers Title to abstract properties it desired to buy, and as a special engagement under that contract, desired that it be informed of any use restrictions that would disable it from operating a restaurant in a particular location. Lawyers Title failed to abstract a "no restaurant" covenant in a prior deed, and as a result, Red Lobster was delayed in opening some five or six months, and therefore lost profits of $78,000 or so. As previously stated Arkansas law holds that before a defendant may be held liable for special damages such as loss of profits, it must appear that at the time of the contract he knew of the special circumstances out of which the damages would arise, and furthermore, that he tacitly agreed to be bound to more than ordinary damages in case of default on his part. *Hawkins v. Delta Spindle of Blytheville*, 245 Ark. 830, 835-36, 434 S.W.2d 825 (1968). This holding was recently re-affirmed in *Bankston v. Pulaski County School District*, 281 Ark. 476, 480, 665 S.W.2d 859 (1984). Consequently, the Red Lobster plaintiff did not want his case in contract, since such a sounding would limit his damages to, at most, the diminished value of the property, probably a few thousand dollars at most. Judge Woods held that he might sue in tort.

Furthermore, to the extent that *Red Lobster* could ever be considered a contract case, it would be so considered because of a factor not present on the face of those pleadings: the Red Lobster pleadings contained a "special engagement", *i.e.* to search for and report all relevant use

restrictions on the subject properties. This duty was expressly contractual, and existed separate and apart from any general duty of ordinary care implied by law. To the extent, then, that *Red Lobster* allowed a plaintiff to sue for the non-performance of a special engagement in tort, rather than confining his remedy to contract, the defendants' position on this motion is bolstered rather than weakened.

Defendants argued, the magistrate opined, and the plaintiffs do not really seem to contest that the "majority rule" and "better rule of law" is that misfeasance in the context of a contract for professional services sounds exclusively in tort, *see Cherokee Restaurant, Inc. v. Puisar*, 428 So.2d 995, 997-98 (La.App.1983). As mentioned, plaintiff suggests on the strength of the five cases treated above that concurrent remedies are all allowed in this state. The foregoing discussion of these precedents leaves the court unconvinced that Arkansas departs from the majority rule.

Whether an action may be allowed to proceed in tort or contract is an issue relicted from days of your when barristers fought pleading wars under the old forms of action. As Judge Arnold of our district, quoting Lord Raymond, C.J., in *Reynolds v. Clark* (1725) 1 Strange 634, at 635 said: "It was deemed necessary to 'keep up the boundaries of actions' or the unthinkable would happen: 'we shall introduce the utmost confusion.' " Arnold, *Select Cases of Trespass from the King's Courts 1307-1399*, London, Selden Society, 1985, ix, n. 1. The court has considerable sympathy for Lord Raymond, indeed for Chicken Littles everywhere, having worked through the arguments and authorities advanced by counsel. Today's

case bears pleasing witness to the progress we as a people have made in streamlining the litigation process over the past two-and-a-half centuries. What formerly would have taken over a year – *i.e.*, to require a validly served defendant to answer over after demurrers, traverses, etc., etc. – now only takes thirteen months or so. "The forms of action are dead," said Maitland, "but they rule us from the grave."

Perhaps in an attempt to undo the sort of confusion that obtains when arguments erupt over whether a suit may "sound" in tort or contract or both, the Arkansas Supreme Court has said, in *Atkins Pickle Co. v. Burrough-Uehrling-Brassuell*, 275 Ark. 135, 138, 628 S.W.2d 9 (1982): "The purpose of the law of contracts is to see that promises are performed; the law of torts provides redress for various injuries . . . "

It appears in this case that the plaintiff's complaint protests the injury caused by bad performance more so than the failure to embark upon a promised course of performance. The complaint therefore sounds in tort, and not in contract, *see, e.g., Miller v. Mintorn*, 83 Ark. 918 (1904).

COUNT VI: VIOLATION OF FEDERAL AND STATE SECURITIES LAWS

The sixth count of the consolidated complaint charges the defendants with state and federal securities laws violations. The count asks for damages on behalf of both the class and the Co-op. The court has initial difficulty understanding how the Co-op can be an injured party in a securities fraud case.

First, the complaint generally alleges that with respect to the sale of the Co-op demand notes, the purchasers were defrauded by being told that the corporation's financial picture was healthier than it was. An investor might very well be willing to invest his funds at 6 or 7% in a sound and healthy institution, but if he were asked to entrust his money in an insolvent or nearly insolvent business, he might require a very much higher rate of return on his money, or he might forego entirely investing in the enterprise. Under this analysis, the Co-op *actually profited* from the sale of demand notes, since it acquired capital at a much cheaper price than it would have to pay in an arm's length, market transaction, stripped of fraud.

The plaintiffs suggest that the Co-op was artificially maintained in its existence by White *et al* so that White could loot the company, and thereby suffered damage. If so, the damages were not suffered "in connection with" the purchase or sale of a security. They happened *subsequent to* the sale, and not even as a result of the sale. For this reason, a cause of action for the Co-op for violation of Section 10, and Rule 10(b)(5) of the Securities Exchange Act of 1934 must be dismissed. The Co-op suffered no damage "in connection with" the transaction; to the extent that it later became arguably liable for damages to shareholders and investors, this damage was not suffered in connection with the sale. *See, generally, In re Investors Funding Corporation of New York Securities Litigation*, 523 F.Supp. 533, 539-40 (S.D.N.Y.1981).

The Securities Act of 1933 prohibits a party from selling unregistered securities through the mails or in

interstate commerce, or those without qualifying prospectuses. 15 U.S.C. Sec. 77e. In the event that such a security is *sold* without registration on prospectus, the buyer may, at his election, sue to recover *the consideration paid* for such security. 15 U.S.C. Sec. 77*l*. The complaint does not allege that the Co-op bought securities, or that it suffered any damage from buying the securities. Therefore, the Co-op would be limited by the language of 15 U.S.C. Sec. 77*l*(2) to recovering the consideration paid less any income received, plus interest. If he no longer *owns* the security, he may sue for damages.

The Co-op asks damages for *indemnification* on the theory that *if* the class plaintiffs are successful in "rescinding" the transactions under federal law they will *owe* the plaintiffs the amount invested plus interest, or under state law the amount owed plus six percent interest. Ark.Stat.Ann.Sec. 67-1256 (1980 Repl.). That is, the Co-op complains that it will have to pay, as damages, less than it would have had to pay for the use of the money if it had applied for it through normal commercial channels. There can be no question but that all funds collected by the Co-op were used by it for corporate purposes, except perhaps those "looted" by White and White-related enterprises in "sweetheart deals" (Par. 47-49). If these "demand notes" did *not* contain on their face an unconditional promise to repay the amounts advanced with interest – if in short they were a typical speculative security in which the investor takes a risk that stock prices will "fall" – then the court could have more sympathy with the concept that the Co-op had suffered injury from the acts of the defendants. That is, the Co-op *by law* would be obliged to pay an amount of money, because its directors

sold unregistered stock, which it would not otherwise have been obliged to pay under its contract with its shareholder. But in this case, the Co-op's contract with its investor specifies that *it will* pay the face amount of the note, plus interest. The Securities Act of 1933 adds nothing to the Co-op's liability than that which it had already agreed to assume at the moment the note was issued. For reasons discussed generally in *Cenco, Inc. v. Seidman & Seidman*, 686 F.2d 449, (7th Cir.1982), the court believes that the Co-op has not, under the pleadings, suffered injury or damage as a result of these acts, and that its cause of action should therefore be dismissed; alternatively, the Co-op, as a "seller" does not have a cause of action under the Securities Act of 1933, and its damages, if any, were not suffered "in connection with" the sale of a security under Sec. 10 and Rule 10(b)(5) of the Securities Exchange Act of 1934.

With respect to the class's claims under federal and state securities laws, the court is aware of the contentions by the defendants that the Co-op demand notes are not "securities" within the meaning of the statutes. The court is open to argument on this point, but not at this time. The statutes all define a "security" as a "note" or "evidence of indebtedness," 15 U.S.C. Sec. 77b(*l*), 15 U.S.C. Sec. 78c(a)(10), Ark.Stats.Ann.Sec. 67-1256 (1980 Repl.). The court can certainly appreciate how the legislatures might very well conclude that a broad-scale, uninsured, unregulated investment program such as the Co-op offered requires a measure of protection for the public such as might be obtained through registration, with an civil liability imposed for fraud or misleading statements,

as well as failure to submit one's self to registration and oversight.

The court will therefore overrule the defendant's objections to Count VI of the Complaint, saying that the class states a cause of action against the defendants. The court will reserve for summary judgment any questions defendants may wish to raise concerning the applicability of the statutes to the demand note program, the individual liability of defendants cited by the Complaint (*i.e.*, Rimmer) and limitations questions – as well, of course, as any questions which the parties otherwise feel resolvable by summary judgment. The record is not developed to the point that the court feels confident that matters as grave as these can be resolved in summary fashion at the pleading stage.

COUNTS VII & VIII: FRAUDS, MISREPRESENTATIONS AND BREACHES OF FIDUCIARY DUTIES

Counts seven and eight charge that Ball and Mourton constructively defrauded the Co-op by representing both it and Jack White, and assisting him in transferring White Flame to the Co-op and releasing him from his $4 million obligation on notes guaranteed by him between January and December, 1980. As discussed in Count I, *supra*, these causes of action belong to the Co-op and not to the class. They will therefore be dismissed as to the class. The Co-op will be allowed to proceed on these causes of action in its own name.

COUNT IX: CITIZENS BANK CAUSE OF ACTION

This matter is moot and awaits presentation of apt orders from counsel from the Co-op and the Citizens Bank of Van Buren.

COUNTS X & XI: NEGLIGENCE BY DIRECTORS AND ATTORNEYS

Count X charges negligent, but non-fraudulent, directors with damages suffered by the Co-op as a result of mismanagement; Count XI charges the Co-op's attorneys (Ball and Mourton, Creekmore and Harriman) with negligently advising the Co-op in the conduct of its affairs. These counts may only be asserted by the Co-op, not the class, for reasons discussed in the discussion of this issue in Count I, above. The class claims will be dismissed; the Co-op will be allowed to proceed, subject to any future motions for summary judgment regarding the statute of limitations, etc.

COUNT XII

In Count XII, the Co-op and the class assert a claim against the attorneys for breach of contract by negligent performance. For reasons advanced in the discussion with respect to Count V, this cause of action is dismissed as to both the Co-op and the class.

COUNT XIII

The plaintiffs' cause of action embodied in Count XIII of the consolidated complaint charges all defendants with

R.I.C.O. violations causing damage to the Co-op and the class. The R.I.C.O. pleading appears to identify February, 1980, as the starting point of the scheme to defraud (Par. 160). This would coincide with the "back dated" sale of White Flame to the Co-op, or the approximate point at which the Co-op began making unauthorized loans to White to enable him to operate the gasohol plant, loans which ultimately totaled $4 million before they were finally "forgiven" in the Chancery Court action.

The plaintiffs allege that the defendants, through a pattern of racketeering activity, damaged the Co-op by foisting off on it a worthless asset driving it into insolvency. At the point of insolvency, the fraud, which initially operated against the Co-op's interest alone, began to inflict damage on the demand note holders who extended credit to the entity based on the representation that their funds were safely placed with a solvent and trustworthy enterprise.

The alleged R.I.C.O. violations, then, had serial victims: first the Co-op, then the noteholders, whose capital was needed to allow the Co-op to proceed in business so that the perpetrators of the initial fraud could better conceal their actions. As the court has noted in its discussion of Count VI (the allegation of securities fraud) at the point of insolvency the Co-op became an engine of fraud, not a victim of fraud. The demand note program permitted the Co-op access to capital at a lower rate of interest than it would have been able to get in the market, and this was so, according to the complaint, because the Co-op successfully misrepresented its condition to the noteholders.

Counsel for Moody has argued that the class may not prosecute a R.I.C.O. claim in addition to the one prosecuted by the trustee. *Carter v. Berger,* 777 F.2d 1173 (7th Cir.1985). The situation in *Carter* was quite different, however. The damages to the class did not necessarily result from damages to the defrauded entity, *see* 777 F.2d at 1177. Even if they did, the court adopted the "passing on" rule of the antitrust law to allow only the directly injured party to sue. *Cf. Illinois Brick v. Illinois,* 431 U.S. 720, 97 S.Ct. 2061, 52 L.Ed.2d 707 (1977).

Here the damages are totally distinct, and with respect to the use of the mails to solicit or defraud in the context of demand note investments, class members are the only "injured party" and therefore the "real party in interest" for such damages under F.R.C.P., Rule 17(a).

A number of other objections have been presented by various defendants with respect to the R.I.C.O. claims. Accountant and lawyer defendants have disputed the assertion that they "controlled" the Co-op so as to defraud any class members, *citing Bennet v. Berg,* 685 F.2d 1053 (8th Cir. 1982). On remand, the district court in *Bennet v. Berg,* 80-381-CV-W-O (W.D.Mo. June 21, 1984) found the requisite "control" existed under the amended pleadings. This court does not feel bound by that resolution in any sense. It merely notes that "an argument" can be made that non-directors and non-employees of an enterprise can "control" it. In this case, the pleadings make more than an argument that lawyers, for example, controlled the affairs of the Co-op enterprise. The complaint alleges that White "dominated" the Board, and that his lawyers (who were also the Co-op's lawyers) drew up the pleadings which foisted White Flame off on the Co-

op. The complaint alleges that this was a $4-7 million transaction, a quite sizeable one relative to the total assets of the Co-op. It could not have been finalized "but for" the activities of the lawyers in concert with White, a dominating party. The complaint alleges sufficient control over the Co-op through White to take plaintiffs past the pleading stage *vis a vis* the attorneys. Similar, albeit not as forceful arguments can be made with respect to the accountants.

In short, the court believes that the complaint states a R.I.C.O. cause of action against the defendants. Defendants wishing to submit summary judgment arguments on issues such as "control" or "aiding" or limitations, etc., are certainly invited to do so. To dismiss the complaint at this point, however, would in many if not all cases be giving ear to speaking demurrers. Because the complaint adequately states a cause of action against all defendants, their motions are overruled.

COUNT XIV: VIOLATION OF "LITTLE FTC" AND CONSUMER PROTECTION ACTS

Count XIV alleges that defendants violated the Consumer Protection Acts of Arkansas and Oklahoma by selling the demand notes by means of misrepresentations. Ark.Stat.Ann.Sec. 70-913 removes from the purview of the Consumer Protection Act those transactions governed by the State Commissioner of Securities. The Arkansas statute, therefore, has no application to this situation.

The Oklahoma Statute does not contain the same language as Arkansas'. The court is convinced, though,

that it does not apply. Indeed, only the rare state consumer protection statute concerns itself with sales of securities. *See, Swenson v. Englestad,* 626 F.2d 421 (5th Cir.1980) (stock certificates not "goods or tangible chattels" under Texas act.)

To the extent that the state acts may be seen as prohibiting lawyers and accountants from "any deception, fraud . . . in connection with the sale or advertisement of any goods or services," *see* Ark.Stat.Ann.Sec. 70-904, the complaint is void of any allegation that any lawyer or accountant fraudulently induced the Co-op to secure his services. Alternatively, the court believes that this statute was not designed to regulate the lawyer-client or accountant-client relationship.

In short, all causes of action, whether raised by the Co-op or the class, brought under the consumer protection acts of Arkansas or Oklahoma will be dismissed.

COUNT XV: VIOLATION OF ARKANSAS CRIMINAL CODE

The law of Arkansas does not imply a private right of action for violation of misdemeanor statutes. Ark.Stat.Ann.Sec. 41-2307 (1977 Repl.) which criminalizes the offense of receiving deposits in a failing financial institution, has no application to the facts alleged in the complaint, which recites that the Co-op is a "co-operative corporation" (Par. 1), not a financial institution.

COUNT XVI: TRANSFERS BY INSOLVENT IN VIOLATION OF ARKANSAS COMMON LAW

This cause of action seeks to avoid all transfers which caused the Co-op to become insolvent. The count infers that the White Flame transfer is mentioned in this context. The court is inclined to dismiss this cause of action, since it is reliably informed that the trustee has filed suit against the architects, designers, builders, etc. of the White Flame plant for breach of warranty, etc. The court views such a lawsuit as amounting to a ratification of the transfer. Either this lawsuit, or the other one against A.C.R., etc., needs to be dismissed. The court will therefore dismiss this cause of action, giving plaintiffs ten days to file an amended pleading specifying which transfers, if any, it wishes to avoid, and whether such an action should be filed in bankruptcy court first, or in this court as an original matter apart from bankruptcy.

COUNT XVII: FORFEITURE OF COMPENSATION BY CO-OP OFFICERS AND DIRECTORS

This cause of action asks that Co-op officers and directors forfeit their pay because of their breach of fiduciary duties. This action may be maintained by the trustee, but not by the class.

D. SUMMARY

The court has acted to clarify which causes of action belong to whom, rather than to pass on questions of the sufficiency of pleadings which, at times, appeared conclusory on questions of "control" of an enterprise, etc.,

etc. The court's reasons were manifold. Primarily, the court hopes to prepare this lawsuit for trial in the most fair, expeditious, and efficient way possible. To require more pleading is counterproductive. This court has gone on record as supporting sanctions under Rule 11 against any party or attorney who persists in keeping a party in a lawsuit, or maintaining a spurious defense, after it has become apparent through discovery that the claim or defense is no longer justified by the evidence. The court trusts that the parties will examine their case with this admonition in mind, and make whatever adjustments as will further promote the orderly resolution of this dispute.

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91-877
No. 91-

Supreme Court, U.S.
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In The

Supreme Court of the United States

October Term, 1991

ERNST & YOUNG,

Petitioner,

v.

BOB REVES, ET AL.,

Respondents.

Petition For Writ Of Certiorari To The United States Court Of Appeals For The Eighth Circuit

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI

VOLUME II

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APPENDIX C

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as Trustee of the Farmer's Co-Op of Arkansas & Oklahoma, Inc.; BOB REVES: FRANCES GRAHAM: ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds — PLAINTIFFS

v. — Consolidated Cases No. 85-2044
85-2096
85-2155
85-2259

JACK E. WHITE, ET AL. — DEFENDANTS

MEMORANDUM OPINION

I. INTRODUCTION:

In *Robertson v. White*, 633 F.Supp. 954 (W.D. Ark. 1986) we tested the legal sufficiency of the plaintiffs' consolidated complaint. We tried to make it clear at that time that our purpose was to determine which allegations could sustain a cause of action under the most liberal and indulgent construction. Even so, the court was greatly troubled by certain of the plaintiff's claims. We suggested that some of them may very well have been barred by the statutes of limitations. Instead of dismissing them at that

point, we advised the parties that we would rule on the questions later, in connection with motions for summary judgment. In addition, we expressed reservations about the applicability of certain causes of action to the parties. In this connection, we were doubtful that R.I.C.O. questions could be raised against the work of auditors, based on *dicta* in *Bennett v. Berg* 710 F.2d 1361 (8th Cir. 1983). The passage of time has brought with it two recent Eighth Circuit civil R.I.C.O. decisions which raised for our consideration vexing questions whether any of the defendants had been shown to have operated an enterprise "through a pattern" of racketeering activity. *See, Fulmer v. Superior Oil Co.*, 785 F.2d 252 (8th Cir. 1986) and *Holmberg v. Morrissette,* Civ. 85-5138 (8th Cir., slip. op., Sept. 3, 1986). That the court of appeals for our circuit would overturn two verdicts, the factual findings of which are to be deemed controlling unless "clearly erroneous" FRCP, Rule 52(b), indicates to us that the court to whom we are immediately responsible has developed and is developing a requirement for pattern fundamentally more rigorous than one which it suggested might be appropriate in *Alexander Grant v. Tiffany Industries,* 770 F.2d 717, 718 n.1 (8th Cir., 1985). Those who thirst for consistency in the law can find their solace in the fact that *Alexander Grant* explicitly said that it was not passing on the sufficiency of a showing of pattern in its decision, was judging (as we did) only the sufficiency of a pleading, and, coming a year before *Fulmer* and *Holmberg,* can hardly be said to be the final word on the topic. It may be possible that our system of notice pleading will permit still more R.I.C.O. cases to enter discovery, since "pattern", unlike fraud, may not have to be specifically pleaded. It is

probable, therefore, that cases under a Rule 12 examination will continue to confuse the resolution of motions arising under Rule 56. The sufficiency of the plaintiffs' case is here today subjected to a more rigorous screening than the one which we pursued a half a year ago. In that connection, too, the rules for decision have changed. Whereas formerly the Eighth Circuit enjoined that motions under Rule 56 be denied if even the "slightest doubt" was present, *Traylor v. Black, Sivalls, and Bryson*, 189 F.2d 213 (8th Cir., 1951); now the trial courts are admonished to enter judgment against parties where no reasonable jury could find for them on the best construction of facts submitted in support of their case. *Anderson v. Liberty Lobby, Inc.*, 54 U.S.L.W. 4755 (June 23, 1986). We do not sit as triers of fact, and make no credibility determinations, since under our Constitution, that lies with the province of the jury. U.S. Const., Amendment 7. Rather, we determine whether, for example, the plaintiffs' evidence, *if believed*, suffices to present a factual question subject to resolution by a jury. If not, we enter judgment for the moving party, as we did for plaintiffs on their securities law claims a few months earlier. *Robertson v. White*, 635 F. Supp. 851 (W.D. Ark. 1986).

If it appears to the professional reader that the court is writing far too pedantically, we plead guilty and offer by way of explanation our hope that members of the press, who will read this opinion and broadcast its holdings extensively in the week before trial commences, will take special pains to inform its audience that the court is making no factual findings in this opinion, only deciding whether plaintiffs should be allowed to present all or part of their case to a jury. Parties on all sides of the case have

remarked that an extraordinary amount of press coverage seems to have developed out of this lawsuit. This is understandable in a case involving 23,000 plaintiffs and nearly 40 defendants. Defendant Creekmore is a well-known member of the community, having served as a circuit judge for several counties in this federal division for 20 years. Other of the defendants are professional accountants and lawyers with fine reputations in the community. The court is therefore concerned that persons reading this opinion not "misreport" the court's legal conclusions to the public. The plaintiffs have made a number of allegations against the defendants. This opinion finds that some of them may not be presented to a jury, and that others can be. That is all. The sole aim of this opinion is to determine whether a juror, *if he believed the plaintiffs' evidence and the most reasonably favorable interpretation of it,* could decide the case adversely to defendants. It goes without saying that no juror is *bound* to hold against them because of anything we say or do here. The court is very concerned that the press exercise extreme care in advising the public of the very limited nature of our inquiry, so that no needless prejudice will attend the parties' quest to draw a fair-minded jury from the seven counties in our federal division. We believe that the press has done a good job in this respect, and will continue to do so throughout the remainder of these proceedings. We would feel very uneasy, this close to trial, to release these opinions without appropriate cautions. With this in mind, we will proceed to examine the record on defendants' motions for summary judgment under Rule 56 of the Federal Rules of Civil Procedure.

II. COUNT I: RETURN OF FEES PAID BY THE CO-OP:

Defendants Ball and Mourton, attorneys at law, and the Arthur Young accountants, have moved for summary judgment on the trustee's cause of action under Count I of the Consolidated Complaint, wherein he asks for a return of all moneys spent by the Co-op for the defense of Jack White and Gene Kuykendall in a federal criminal action styled *United States of America v. Jack White and Gene Kuykendall*, CR-80-20028-01, 20028-02, (W.D. Ark., Sept. 5, 1980 – January 23, 1981), *affirmed*, 671 F.2d 1126 (8th Cir. 1982).

The basic facts have previously been set forth in this and court's opinion, *Robertson v. White, et al.*, 633 F. Supp. 954 (W.D. Ark., 1986). The parties have amplified the record for purposes of their motions for summary judgment on this count, and the Court, necessarily, will too. We understand that the test for granting a summary judgment after *Anderson v. Liberty Lobby*, 59 U.S.L.W. 4755 (June 24, 1986) requires the court to examine the record to determine whether a reasonable jury could find in favor of the non-moving party on his claim or defense. Our analysis will therefore be conducted along those lines. This opinion will primarily treat the arguments advanced by Ball and Mourton. The court believes that an extended treatment of their claim provides the easiest *entree* into a discussion of the motion made by Arthur Young and the Creekmore "submission". (Carl Creekmore's July 22, 1986, motion for summary judgment does not specifically address the Court I claim; it will be addressed tangentially in this motion.)

On September 5, 1980, the Grand Jury indicted White and Kuykendall for wilfully subscribing a corporate tax return which they knew to be inaccurate in material respects (2 counts) and for conspiring to violate 26 U.S.C. Sec. 7206 by filing a materially inaccurate return (1 count). The indictment said that Jack White had engaged in a course of self-dealing activity with the Co-op, and had disguised his conduct by submitting a false return. It is true that the indictment did not charge him with self-dealing, *per se*. There is no federal crime of self-dealing. But at the very basic level of wanting to know "what they said he did," a person would be justified in reading the indictment as having alleged that Jack White had been involved in self-dealing with Co-op assets. Indeed, another reading of the indictment would be technically correct, but such a perfection in understanding the indictment is inessential for these purposes, which only seek to determine whether a reasonable person would have suspected or concluded that White's stewardship of the Co-op was under fire. Taking that as our measure, we apprehend that the Grand Jury substantially averred that Jack White operated the Co-op's business on numerous occasions at less than arm's length. This is the conclusion drawn by the court of appeals, *United States v. White*, 671 F.2d 1126, 1128, (8th Cir. 1982) ("the indictment charged that White had engaged in a course of self-dealing"). It would be obviously futile to suggest that a reasonable jury could not find, as a fact, that the indictment put persons on notice of White's history of self-dealing, in the face of the Court of Appeal's characterization of it.

On September 8, 1980, the Co-op met with Ken Mourton, who discussed the indictment with them. Following

questions by the Board, the directors passed a resolution expressing confidence in White, stating that there was "no money missing" from the Co-op. On December 11, 1980, the directors passed a resolution authorizing the Co-op to pay the legal fees and expenses incurred by White and Kuykendall. The petit jury convicted the defendants on all counts on January 23, 1981, after a fourteen day trial. The court of appeals affirmed the judgment on February 26, 1982.

The record would support a reasonable jury's finding that the I.R.S. began an investigation of the Co-op in December, 1976, and in February, 1977, decided that the transactions it had examined merited screening by its criminal investigation division. In May, 1977, Jack White asked the Board for authority to hire tax specialists for the Co-op which, at that time, was itself under civil and criminal tax investigation by the I.R.S. The Co-op authorized White to do this, and on May 16, 1977, the Co-op hired E. J. Ball and Ken Mourton, d/b/a Ball and Mourton to represent it in the on-going investigation covering calendar years 1973, 1974, and 1976. (BMA Statement of Undisputed Facts, Par. 18). The Co-op continued to use the services of Ball and Mourton up until the Co-op filed for bankruptcy in February, 1984. Thereafter, the bankruptcy court retained Ball and Mourton for the estate until October, 1984. *Id.*

A reasonable jury could find that experienced men of affairs, at the highest levels of their professions, would understand the indictment as *alleging* that White had self-dealt with the Co-op; furthermore, on the record, such men would have been able to appreciate the dimensions of the Government's complaint at some earlier time, since

there were numerous meetings with the Government in the pre-indictment stage. An objective review of some of the transactions giving rise to the 34 "overt acts" in the conspiracy count would reveal a pattern of unlawful fiduciary behavior practiced by White, the Co-op's general manager. (Indictment, BMA Exhibit 14, pp. 378-79). For example, in 1974, the City of Van Buren, Arkansas, financed the construction of the modern Co-op complex by issuing $1.5 million in Act 9 bonds. Jack White bought them all. The Co-op loaned White $1.5 million at no interest to buy them, and paid 8% interest to him as a bondholder. White took the interest in lieu of his yearly bonus, as we understand the testimony of the criminal trial, so the deal is not quite as bad as it sounds. However, to this date, no one has suggested a plausible explanation why it was advantageous for the Co-op to structure the transaction in *this way*. Had the Co-op kept its $1.5 million and sold the bonds, or even tried to, it would still have saved "property taxes" and would still have paid the same "low" interest rate [Ball, Affidavit, Para. 11 (e)(i) and (ii)]. By using its own money (presumably demand note proceeds,) the Co-op was borrowing money at 8% from note holders (the rate paid notes from May, 1974, to September, 1976, when it dropped to 7% [Ball, Affidavit, 916(f) p. 9]) in order to loan that same money to White, so that White could indirectly loan that same money back to the Co-op at 8%. The Co-op paid 7% to noteholders from September, 1976, to July 1, 1977; so for a time the Co-op paid White more. In any event, there is one clear winner here: Jack White. It appears from this scenario that the aim and end of this transaction when all the corn has been shucked, was to give Jack White tax-

free income. Certainly, he did not energetically market bonds, and had no incentive to. The corporation would have had an incentive to have the bonds marketed, since that would replenish funds taken from current assets. As the transaction stood, demand note funds were used to purchase long term assets, depleting the current ratio. At the very least, the corporation suffered an adverse effect on its current ratio in order to give White tax-free income.

One question, therefore, bothers the court: if this transaction were *bona fide,* why have all the lawyers and accountants failed to come up with a plausible reason for it? The lawyers and accountants obviously have a motive for advancing such an explanation *if it exists,* since otherwise they run the risk that a reasonable jury may conclude that experienced men of affairs read and understood the indictment in its general signification, and that they furthermore, upon investigation and reflection, could have determined that the allegation that White profited at the expense of the Co-op was probably true. Such a conclusion has serious implications for the resolution of motions under Count I of the complaint. The court does not gainsay that criminal defense counsel have the undoubted right vigorously to contest any adverse characterization of a client's activities or motives by the Government; that, in fact, is their duty, upon the performance of which all our liberties depend. That is not in question. Count I asks the question from whom such an advocate may expect his pay after he is done saying his piece. Can a lawyer reasonably expect a corporation harmed by his client's activities to pay legal fees for defending the client against a criminal indictment which calls into question the very acts which harmed it?

The indictment, in fact, exhibits a pattern of such conduct engaged-in by White and Kuykendall. In another example, in 1974, the Co-op stored surplus fertilizer at a time when Nebraska farmers were facing a shortage. The Co-op through White arranged to sell the product at a premium price. Not all the receipts from the sales were recorded as belonging to the Co-op. Instead $240,000 of the receipts found their way into demand note accounts of fictitious individuals. It is possible for a jury to conclude that this was done, as White and Kuykendall swore, to create a "reserve" for fertilizer which "caked" in the Co-op's storage bins that summer, although the juror would have to wonder why the artifice of the bogus accounts was created for this purpose.

Contrarily, a reasonable juror could conclude that this artifice was intended to benefit White. Soon afterwards, $225,000 was moved back into the Co-op when the bogus noteholders "bought bonds." White's loan account was reduced $225,000. The Co-op paid the bogus noteholders 8% interest on their "bonds." Could not a reasonable jury conclude that the imaginary demand note accounts were created in order to give White access to the funds?

The court believes that on balance a reasonable juror could conclude that this artifice was contrived in order to benefit White, and that a reasonably experienced professional would grasp this almost immediately. The jury which convicted White and Kuykendall may very well have concluded that White's "caked fertilizer" explanation did not hold water. First, the suggestion that defendants created a "reserve" for ruined fertilizer did not surface until long after the investigation commenced.

Second, the weather data did not support the defendants' contentions. The very kindest interpretation one can put on matters is that White and Kuykendall hatched this scheme simply to save the Co-op some taxes, since the sales to the Nebraska farmers were non-patronage-based and therefore fully taxable. Of course, this interpretation ignores the fact that such a goal could have been achieved more simply and expediently, with no devious devices at all, simply by making the Nebraskans members of the co-operative. Alternatively, White and Kuykendall may have wished to avoid making the Co-op pay a "patrongage dividend" to the Nebraskans, which would have had to have been done if they paid $10.00 to become members. The court believes that a reasonable jury may come to a conclusion which is more easily understood in these parts: that the bogus accounts were created so that White could draw on and use the money between July, 1974, and January, 1975. The court has examined the accounting system used by the Co-op for demand notes, and believes that in the case of a fictitious payee, it would be more than possible to, in effect, "keep two sets of books," using the money at will, and to create an essentially bogus paper record of the transactions, because there appears to have been no effective controls which would have prevented that from happening.

The relevance of this discussion to our problem is that the allegations in the September 5th indictment are such that a jury may reasonably conclude that BMA were actually aware that White had pursued a course of action inimical to the Co-op, or at least were on notice of the potential conflict. Nor were these two examples the only ones. The indictment also alleged that White borrowed

$1.2 million from the Co-op at ten percent, only to turn around and loan it to his associates at twelve percent. The court does not intend to enter the *lacunae* of whether this opportunity was truly a corporate opportunity which White misappropriated. The issue is: how can a corporate servant conscientiously pursue his duty to get the most of his master's dollar, when he intends himself to loan that money to a third party and make a profit for himself?

The court believes, in short, that a jury could find that possibly in 1977 when Ball and Mourton first agreed to work for the Co-op, and almost certainly by 1978, when the attorneys were briefed as to the dimensions of the criminal case by the I.R.S., Ball and Mourton were in a position to appreciate the conflicts, real and potential, in representing both White and the Co-op.

Ball and Mourton appear to concede the applicability of *Raines v. Toney*, 228 Ark. 1170, 313 S.W. 2d 802 (1958) to this question. They suggest that *Raines* holds that third parties (presumably, in this case, Ball and Mourton) may be liable to a plaintiff whose fiduciary injured him, only if the third party knowingly assisted the corporate officer in breaching his duty to the plaintiff. The BMA brief questions whether the record supports that (a) White breached a fiduciary duty to the Co-op by accepting indemnification for his legal expenses, and (b) whether BMA knowingly assisted him in doing so. (BMA, Brief, p. 7).

The case at bar is far stronger than *Raines v. Toney, supra*. Here, the third party is itself a corporate fiduciary. Here, the third party received the full benefit of the moneys misappropriated from the Co-op to indemnify

White, contrary to law. The case brought by the Trustee is stronger, by far, than the one brought by the bankruptcy trustee in *Proctor v. Norris*, 188 N.E. 625 (Mass., 1934). In *Procter*, one MacClaskey controlled the bankrupt Phoenix Bond and Mortgage Co., and also owned an interest in a concern called Hodgdon, Cashman & Co., which was in financial straits, to the extent that some of its customers were asserting claims against MacClaskey personally. In December, 1927, MacClaskey went to defendant, a newly licensed lawyer, and told him that he wished to pay Hodgdon-Cashman creditors out of his own pocket in a way that Cashman would be required to repay the lawyer. The attorney, Norris, set up a trust account from which to pay creditors at MacClaskey's direction, and agreed to receive from Cashman notes for the amounts of the checks. MacClaskey told Norris that he wanted Cashman to believe that Norris himself was extending credit to Hodgdon-Cashman, and Norris undertook the task, believing MacClaskey was using his own funds as represented. *Id.*, at 626.

In fact, without authority, MacClaskey drew checks to the lawyer's order out of the Phoenix Bond & Mortgage Co. account, signing them as Treasurer. The court found that Norris, though acting honestly and though ignorant of whether Phoenix Bond was a corporation or not, could easily have discovered the truth. The court determined that the defendant knew that the checks were drawn for a purpose unconnected with the business of Phoenix Bond, and charged the lawyer with notice that MacClaskey (who was president, treasurer, majority shareholder, and [essentially] the total board of directors of Phoenix) was not empowered to draw off corporate

funds in order to pay Cashman's creditors. Pointedly, the court observed that the defendant "though acting honestly and though ignorant as to whether the company was a corporation or not, could easily have discovered the truth," *Id.*, at 626. The court noted that even with innocent purpose, the lawyer knew that the checks were unconnected with the business of the Phoenix Bond and Mortgage Company, and was chargeable with notice that MacClaskey probably had no right to draw them. The defendant was therefore considered by the court to have come into possession of funds belonging to the corporation, and to have assisted MacClaskey in diverting them to an unlawful use. *Id.*

The *Proctor* court deemed it irrelevant that the young lawyer had not received the money for his own benefit. "An agent of fiduciary who receives trust property and disposes of it in a transaction beyond the legal powers of the fiduciary is liable as a constructive trustee to the beneficiary," the court decided. *Id.* As a concluding matter, the court noted pertinently that "the failure of the directors of the . . . company to perform their duties could not give MacClaskey any right to divert corporate funds, or estop the corporation, the stockholders, or the plaintiff to seek their restoration." *Id.*, at 627.

We believe *Proctor v. Norris, supra,* to be a correct statement of the law, and to the extent that the case at bar differs from it, it does so in ways inclining the balance even more favorably to the Trustee. First, in this case Ball and Mourton were Co-op fiduciaries at the point they undertook White's representation and the Co-op's pay; in *Proctor,* the lawyer owed no fiduciary duties to the Phoenix Bond and Mortgage Co. Second, in this case Ball and

Mourton received the misappropriated moneys; in Proctor, the lawyer disbursed it at MacClaskey's instructions. Third, Ball and Mourton were in a superior position to observe and conclude that the fiduciary White had breached his duties to the Co-op, or at the very least had failed to comport himself with "a punctilio of fairness the most honest"; whereas the *Proctor* defendant appears successfully to have been deluded, and at the very least was never shown an indictment to arouse his suspicions. To the extent that there is a difference, it is this: here the Board passed a resolution, there it didn't. The Proctor *report* persuasively suggests that such a resolution would have been a mere formality in that case. There is persuasive evidence in this case that Ball and Mourton considered the board's consent to the arrangement to be no real impediment to the plan: months before the indictment was issued (itself three months before the board passed the December 11 resolution) Ball and Mourton decided that they faced a conflict in representing Kuykendall. Ball then called Hugh Hardin, a Fort Smith lawyer, and asked him if he would represent Kuykendall, telling him that the Co-op would pay the fees for it. Kuykendall was never an officer or employee of the Co-op. He had not even a colorable claim for indemnity under the statutes. For some reason which Ball and Mourton's summary judgment motion does not address, the Co-op's lawyer was evidently confident that the cooperative would pay Kuykendall's fee; so obviously he must have been confident that it would pay his own. The fact that the Co-op board sealed the pact with no real debate hardly suggests that the result in this case should be different as a matter of fact and law than the result in *Proctor*.

That is, simply because directors abdicate their fiduciary responsibilities to shareholders does not excuse the Co-op's lawyers from their duty independently to investigate the propriety of the payment. The indictment was sufficient notice to Ball and Mourton that a conflict existed to enable the court to say that they ran the risk that they might be deemed constructive trustees to the Co-op. This is most especially so in the case where bankruptcy intervenes. The trustee may prosecute a cause of action based on an unlawful diversion of assets or on a statutory liability created by the law of the state of corporation. That an officer's conduct has been ratified by the board does not avail the defendant. *Neese v. Brown,* 405 S.W. 2d 577 (Tenn. 1964), *noted* 35 Tenn. L. Rev. 673 (1968). The trustee loses his rights only where the transaction sued upon has been ratified by all the stockholders. *Field v. Lew,* 184 F. Supp. 23 (E.D.N.Y. 1960); *See also, Cunningham v. Jaffe,* 251 F. Supp. 143 (D.S.C., 1966). These cases evidently take the position that a shareholder "always could" sue derivatively to recover the assets diverted, and because that power existed "in the right of the corporation" e.g. Ark. Stat. Ann. Sec. 64-223 (1980 Repl.), no action by the board of directors can remove the issue from litigation.

The court therefore believes that summary judgment should be denied Ball and Mourton on Count I of the Complaint. On the law, the trustee succeeds to any right which the corporation had. Certainly White had no right to indemnity under the corporations act. Such a claim could only be justified where White acted "in good faith" in engaging in the underlying conduct. Given that this underlying conduct may reasonably be found to have

been "self-dealing," a Co-op shareholder could have sued at any time, derivatively, to require White and other recipients to disgorge the fees. In such a circumstance, a court may ultimately defer to a board of directors' decision, but it is not required to. Certainly if a court concluded that White's 1973-77 activities as listed by the indictment constituted self-dealing, it would be difficult to conclude that he acted in "good faith" and therefore impossible to defer to the directors' decision. A court would have to conclude that White breached a fiduciary duty by accepting benefits contrary to law. CF. *Assoc. Milk Producers v. Pair,* 528 F. Supp. 7 (E.D. Ark. 1980) (semble).

Having made that determination, a jury could conclude that Ball and Mourton took their fee from the Co-op knowing far more than anyone the presence of actual and potential conflicts presented by White's activities from 1973 through 1977. They therefore assisted and profited from White's acquiescence in a benefit to which he was not entitled.

Concerning the defense of limitations, we are persuaded that the three year limitation applies. Ark Stat Ann Sec. 37-206 (Repl. 1982). *Cooley v. First National Bank,* 276 Ark. 387, 635 S.W. 2d 250 (1982). *McGhee v. Glenn,* 244 Ark. 1000, 428 S.W. 2d 258 (1968). (action to recover money paid by mistake barred in three years). Ball and Mourton continued representing White on his criminal indictment on through March, 1982. Presumably, they were paid for this work by the Co-op. They failed to show, therefore, that all of the money received by them was disbursed prior to February 23, 1981, the relevant date for purposes of computing limitations on claims

brought by the trustee. Under a "continuing wrong" theory (among others) any wrongful receipt of moneys pursuant to an initially wrongful breach of fiduciary duties tolls the limitations period. The defendants Ball, Mourton and Adams' motion for summary judgment on Count I is therefore denied.

Arthur Young's motion stands on slightly different footing. First, they did not receive their fees as fiduciaries of the Co-op. They were witnesses hired by Ball and Mourton and owed no duties to the Co-op during the time they were so engaged. Second, Arthur Young did not ever arguably "assist" the breach of White's fiduciary duties. That is, it may be argued that Ball and Mourton, attorneys for the Co-op, "assisted" the breach of the duty by failing to advise the Co-op when they were otherwise under a duty to speak. (This issue was *not* resolved in the Ball and Mourton discussion, and is only included here for purposes of analysis.) Unlike the lawyers, the accountants had no duty to advise the Co-op on the question whether it should pay White's fees and expenses. The Arthur Young defendants are the most passive vessels among the parties sued in Count I. The directors who were sued passed the resolution authorizing the payment; White and Kuykendall directly benefitted and had a duty to disclaim the benefit arising out of their relationship to the enterprise; Creekmore, the Co-op counsel, presented the resolution for approval and did not (at least) counsel against its passage, and thereby assisted the breach by failing to discharge a positive duty he owed, then and there, to his client; finally, as we say, Ball and Mourton failed to correct their client's appropriation of the money, and directly benefitted from that failure. In

no sense can Arthur Young's conduct in this circumstance be likened to any other party's.

In our view that does not matter. Arthur Young has argued that Count I charges asserts "some kind of tort claim" and protests that "it is a mystery what text Count I purports to assert . . . but it is clear that no viable claim is asserted. Count I alleges only that Arthur Young 'knowingly received' money for professional services – a not surprising fact and one that does not normally constitute tortious conduct." (AY Motion to Dismiss, pp. 8-9).

The court believes that a reasonable jury can find the following: (1) that sometime in 1980, Ball and Mourton hired the Russel Brown (now Arthur Young by merger) firm to provide litigation support to it in the criminal trial of Jack White; (2) that the primary parties to the contract of employment were Ball and Mourton as "parties of the first part" and the Russel Brown accountants as parties of the second; (3) that Ball and Mourton told them that they would be paid by the Co-op, but that the parties knew that the employing party, Ball and Mourton, would remain primarily liable; (4) that this conversation predated the Co-op's December 11 resolution authorizing the payment of fees for White and Kuykendall; (5) that Arthur Young thereafter knowingly received fees from the Co-op (as opposed to fees distributed through Ball and Mourton's Trust Account); (6) that Arthur Young was fully aware that there had been alleged that White had improperly benefitted from what accountants refer to as "related transactions" and therefore was aware, or should have been aware, that the receipt of fees was a related transaction within the meaning of that term; and, (7) that Arthur Young, in August 1981, after having received fees

from the Co-op in January, 1981, accepted an engagement to audit the cooperative's statements, one part of which would include passing on the propriety of the payment of White's fees.

Under this analysis, which a reasonable jury could entertain, Arthur Young should have been aware, similarly to the lawyer in *Proctor v. Norris, supra,* that reimbursement for its services ought to have come from Ball and Mourton in the first instance. They accepted the money notwithstanding its source, and notwithstanding the context; *i.e.,* that they were being paid by the Co-op for the benefit of White against whom allegations of self-dealing had been made.

A reasonable jury may conclude that Arthur Young's acceptance of such funds from a party only secondarily liable (if at all) on the contract between them and Ball & Mourton was such as should have alerted them to the questionable propriety of the arrangement. If the payment be questionable in any case, a jury might reasonably conclude that it is highly questionable in a context where the firm provided services to a corporate employee who was substantially charged with self-dealing, particularly where they were in a position to learn the full details of those transactions (notably the Act 9 bond transaction,) the *bona fides* of which they are to this day unable to explain (or have chosen not to at this time.)

A reasonable jury may conclude that the Arthur Young defendants became corporate fiduciaries (within the scope of their employment) when they engaged to audit the cooperative's financial statements in August, 1981. As fiduciaries (within the scope of their services)

Arthur Young was obliged to pass on the propriety of payments of which they were beneficiaries, and therefore had a duty to investigate anew the propriety of that payment. A particularly disturbing question is presented in this connection. If the Co-op *could* legally have made advance payments for White's defense in a criminal case, the statutes seem to require the officer benefitting from that arrangement to indemnify the corporation in the event that he is convicted or in the event that the payment be otherwise objectionable. The use of the word "advance" in the statute conjures up the image of a "loan" to the officer; that is, something that should be paid back. This "loan" however was never made to the officer; rather, it was made to the accounting firm. Leaving all questions aside whether a payment can be termed a "loan" when it was made for services rendered, by legal analysis the obligation was theoretically callable by the corporation directly or by any one of its shareholders derivatively from the accountants for a period of at least three years after the last payment was made, unless the limitation be otherwise extended. Under that analysis, the payment to Arthur Young is "loan-like," since under that analysis Arthur Young would be required to pay the amount back to the Co-op and make its demand for payment on the parties primarily liable: *i.e.*, Ball and Mourton, or Jack White. To what extent is an auditor independent (See, S.E.C. ASR 234)[1] under that characterization of the problem? If he is not "independent" under

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[1] This Accounting Series Release was recalled by the Securities Exchange Commission in 1981, not because it misstated any principles, but because it was deemed unnecessary.

that characterization, can he pass on the propriety of that transaction in his audit? Does he "toll" the statute of limitations against him, in other words, by issuing an audit report a year later which is silent on whether his services as an expert witness constituted a "related transaction" which needed investigation and/or correction? This consideration impels us to deny Arthur Young's plea of the statute of limitations, which would otherwise be availing since the accountants received their fee more than three years before the commencement of the bankruptcy proceedings. The question of limitation can be, of course, submitted to the jury for decision if Arthur Young so desires.

For these reasons, then, Arthur Young's Motion for Summary Judgment under Count I is denied.

COUNT II. FRAUD, NEGLIGENCE, AND CONSPIRACY IN TRANSFER OF GASOHOL PLANT

A. The Motion of Carl Creekmore

Carl Creekmore, former general counsel of the Farmers Co-op of Arkansas and Oklahoma, Inc., has moved for summary judgment on claims of negligence, fraud, and racketeering brought against him by the bankruptcy trustee for the Co-op, and by the class of members and noteholders of the Co-op. An earlier opinion of the court, *Robertson v. White*, 683 F. Supp. 954 (W.D. Ark. 1986), recited in some detail the allegations against all the defendants in the case. It will not be necessary to repeat all of those. The court will go into greater detail concerning the critical facts surrounding the transfer of the White Flame gasohol plant to the Co-op, and particularly those

circumstances and actions involving Creekmore. Our goal in this recital is to make the kind of findings a reasonable juror could on the basis of the record presented. *See Anderson v. Liberty Lobby,* 54 U.S.L.W. 4755 (June 23, 1986). This is not to say that these "findings" are incumbent on any juror; only that they represent the most favorable findings and inferences a reasonable jury might draw from the conflicting accounts advanced by the parties.

Towards the middle of 1979, Jack White, general manager of the Farmers Co-op, and Edwin Dooley, a Fort Smith businessman with experience in oil and gas, resurrected an old corporation, Big D Solvents, with the idea of building and operating a gasohol plant to make automotive fuel from agricultural products. The two got a loan from the Merchants Bank of Fort Smith and commenced planning the enterprise. White suggests that the one-half interest he owned was always the Co-op's, but a reasonable jury could decide otherwise, since there is scant documentation of his assertion. Furthermore, he claimed White Flame's *entire* loss on his 1979 taxes. In the fall of 1979, Dooley decided to leave the enterprise, and White bought him out, taking a loan from the Citizens Bank of Van Buren. Both White and Creekmore were directors of the Citizens Bank. The loan from Citizens was close to its lending limit for individuals, and when, a year later, it still remained unpaid, the Bank made demands on White.

To get the plant built and into operation, White figured that he would need $3 million in financing, and sought to sell some Act 9 bonds to raise the money. Accordingly, the Little Rock firm of Friday, Eldredge & Clark was engaged to prepare the papers requisite for

that purpose, including an offering statement. A reasonable juror could conclude that Creekmore was acting as White's attorney in this matter, since the Friday firm sent materials to Creekmore under cover of a letter identifying him as White's attorney (Plaintiffs' Ex. 178). The offering statement, a copy of which was given to Creekmore, was hairraising. It is safe to say that none but the most foolhardy would ever have bought bonds whose repayment depended on the success of the gasohol plant.

The court will excerpt certain statements from the bond counsel's report so that one may get a flavor of the discouraging nature of the enterprise. In bold type, the statement says that in the opinion of bond counsel, the bonds were not suitable for investment purposes because of their high risk. Counsel cautioned that the bonds should not be purchased by anyone who could not afford a complete loss of the investment. Inasmuch as Jack White individually was being called on to guarantee the bonds, the statement alerted the reader that one should be wary of the guarantee since it was uncertain that White had the resources to pay it off. Under the terms of the statement, the Farmers Co-op was supposed to buy the bonds, and presumably these cautions were being addressed to the Co-op and anyone purchasing bonds from it.

The offering statement went on to relate that the bonds involved an unusual and substantial degree of investment risk, that they were not suitable for the general public, and that the entire investment stood to be lost. It related that the company was a new entity with no operating history of any type, whose management had no experience, proposing to use an untried process with no

assurance of mechanical success. The Company, related the statement, had no contracts to purchase raw materials and no market for its product. The Company had no resources at its command other than the bond proceeds, no personnel with technical proficiency, and no assured demand for its product. The statement exceeds 40 pages, and is as discouraging a report as one is likely to find.

White dropped the idea of selling bonds to the Co-op at this point, or to anyone for that matter. He began financing the operation out of Co-op cash funds, making notes to it for many hundreds of thousands of dollars at a time, with no security other than his "guarantee." These loans were never authorized by the board. From January, 1980, through October, 1980, they totaled over $4 million.

White claims that in February, 1980, the Co-op board of directors voted to buy the gasohol plant, and Creekmore goes along with this, although he does not recall the exact circumstances of the transaction. A reasonable jury would not be obliged to believe this, however. The minutes are silent on the point, the directors hazy, and the subsequent course of events contrary to the hypothesis. For example, White guaranteed notes from the Co-op to White Flame Fuels (as it was then called) and pursued FmHA financing for the project in his own name, representing the facility as his own. In addition, one board member recalls that a motion was made and seconded to buy the plant in February, but that the motion was withdrawn at the request of Jack White. (McClure Depo., at 118).

Significantly, the contents of the offering statement were never shown to the Co-op by White or by Creekmore, both of whom were fiduciaries. The law required

such a statement to be shown to the board of directors in the event that they were to buy the Act 9 bonds. Of course, in a non-securities transaction, no such statement need be shown. As disclosed later, however, the Co-op, in supposedly buying the plant, purchased the *stock* of White Flames Fuel. The kind of disclosures mandated for securities transactions of that type, however, were never made. *See Landreth v. Landreth Timber Co.*, 105 S.Ct. 2297 (1985).

The gasohol plant began production in April, 1980. All the dismal forebodings of bond counsel were fully realized. The plant, plagued with cost overruns, glitches and snafus, could never sustain production over 25% of capacity, and lost $100,000 a month. Understandably, White was unable to attract FmHA financing for the plant.

In November, 1980, the Co-op board went on record, voting to buy the gasohol plant. The minutes are no more spacious on the subject than that. The record discloses no certain terms, price, time, or anything else considered essential for purposes of contract. White claims that this action was taken to memorialize the February vote. A reasonable jury could conclude otherwise. Evidence shows that a Farmland representative visited the Co-op in November to advise them that they should *not* buy the gasohol plant, and that he was told by White that the plant was still owned by him.

Two weeks after the Co-op voted to buy the plant, Jack White, Hugh Brewer (chairman of the Co-op board),

Carl Creekmore,[2] E.J. Ball (White's attorney on criminal tax fraud charges), and Hugh Hardin met in Hardin's office in Fort Smith. It had been learned that the Co-op might take advantage of certain tax deductions available to the gasohol plant if it could be shown that the cooperative owned the plant prior to the date it commenced production. White and Brewer volunteered that such was the case, and informed the lawyers, Ball and Hardin, that the Co-op had voted in February to buy the plant, but that the vote had not been recorded in the minutes.

Lacking any documentation to show the IRS, in the event that the propriety of the deductions were ever questioned, Ball suggested that the Co-op file a "friendly lawsuit" against White, the purpose of which was to establish ownership by the cooperative on February 15, 1980, more than a month before the plant commenced production.

Creekmore told the lawyers that he lacked expertise and asked Ball, who worked in Fayetteville, to prepare the papers. Hardin volunteered to draft the complaint for the Co-op and deliver it to Creekmore. On November 26, 1980, Hardin delivered the first draft of the complaint to Creekmore, Ball and Gene Kuykendall. This draft recited that on January 1, 1980, White and the Co-op agreed that White should assign his stock to the Co-op, and that the sole consideration for the transfer would come out of the net profits of the plant from 1980 to 1985, but in no case

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[2] Creekmore denies attending this meeting, but the testimony of Ball and Mourton places him there. For purposes of summary judgment, such evidence would allow a reasonable jury so to find.

more than $250,000. The complaint recited that in reliance on that agreement the Co-op advanced $3.85 million to the plant, but that White refused to tender the stock. The complaint sought a declaration confirming the deal as outlined in the pleading, and an order requiring White to turn over the certificates to the cooperative.

This draft evidently did not satisfy Ball, possibly because the date of the agreement was January 1, 1980, rather than February 15. The complaint was redrafted so that the Co-op became obligated to pay White's $250,000 note to Citizens Bank. Besides that, the complaint recited that the entire amount advanced to the plant as loans guaranteed by White would be "considered the [cooperative's] investment" in the plant. This amount apparently ran to $750,000. The complaint then recited that since February 15, 1980, the Co-op had advanced another $2.98 million to the plant. It asked for a declaration that the stock of the gasohol plant belonged to the Co-op, and that the "deal" be confirmed along those lines.

At the December, 1980, board meeting Creekmore announced his retirement, effective December 31, 1980. He made a report to the board concerning pending litigation, and told them that, in addition, the Co-op's tax lawyers (Ball and Mourton, of Fayetteville, Arkansas, also White's criminal tax attorneys) had recommended that he file a declaratory judgment action to establish the February 15 transfer date. Creekmore avers that he fully informed the board of the terms of the lawsuit; the directors, however, though recalling that the subject of such a lawsuit came up, do not testify that they were fully aware of the intents, purposes, and effects of the suit.

The board passed a resolution empowering Creekmore to do whatever was necessary to get the stock in the Co-op's name, but did not specify that a lawsuit be filed. The next day, Creekmore filed the declaratory judgment action, and the following week, after White filed an answer generally denying the allegations of the complaint, Creekmore, White, Brewer and N.D. Edwards, a Van Buren lawyer recruited to represent White at the hearing, procured a decree from the Chancery Court vesting title to the stock in the Co-op's name, and absolving White of all liabilities. By this time, the gasohol plant was a money pit.

The record is clear that at no time did Creekmore ever reveal to the board that he simultaneously represented Jack White, nor did he ever reveal to the board the information contained in the offering statement concerning the advisability of investing in the gasohol plant. The trustee complains that Creekmore's complicity in this affair constituted negligence, fraud and racketeering, as those terms are understood in the common law, as well as under state and federal securities and racketeering statutes. Creekmore argues that certain of the allegations, notably those of fraud and negligence, are barred by the statutes of limitation, and that the evidence does not show federal securities law and anti-racketeering violations on his part.

On February 23, 1984, the Co-op filed for reorganization under Chapter 11 of the bankruptcy code. A principal question for decision under Creekmore's motion for summary judgment is whether he is chargeable with any act occurring on or after February 23, 1981, that would toll the running of the statute of limitations. Under 11

U.S.C. § 108, statutes of limitations barring a bankrupt estate's causes of action against third parties are automatically extended two years, unless such actions were already barred by the time the reorganization proceedings commenced. In addition, so far as relevant, the class filed its claims of fraud against Creekmore on May 8, 1985. These matters of limitations for the common law counts of negligence and fraud will be taken up first.

(1) STATUTE OF LIMITATIONS

A. COMMON LAW

I. Negligence

The statute of limitations in Arkansas for negligence actions against attorneys is three years. Ark. Stat. Ann. § 37206 (1962 Repl.). In *Riggs v. Thomas*, 283 Ark. 148, 671 S.W.2d 756 (1984), the Supreme Court of Arkansas ruled that the limitations period began to run, absent concealment of the wrong, when the negligence occurs, not when it is discovered by the client. Concealment, however, may not be found when a tortfeasor merely remains silent or fails to publish the fact that he has committed a wrong. *Scroggins Farms Corp. v. McFadden*, 165 F.2d 10 (8th Cir. 1948). To toll the statute, some affirmative act needs to be done, unless there is a duty to speak. *Williams v. Purdy*, 223 Ark. 275, 265 S.W.2d 534 (1954). Generally speaking, knowledge of the wrong done is a necessary prerequisite to a tolling of the statute of limitations by reason of concealment. *Cf. Williams v. Edmondson*, 257 Ark. 837, 520 S.W.2d 260 (1975). That is, one cannot negligently conceal a negligent tort so as to be deprived of the benefit of the limitations defense. An attorney is under no special

obligation merely by virtue of the attorney-client relationship to alert his client that he has negligently performed a task so as to prevent the running of a statute of limitations. *E.g., Fortune v. English,* 226 Ill. 262, 80 N.E. 781 (1907).

There does not appear to be any allegation that Carl Creekmore concealed his responsibility for negligent acts. First, in our opinion denying the motions to dismiss, *Robertson v. White, supra,* at 959, we criticized the plaintiffs' complaint for not alleging particular acts of concealment which would take their cause of action beyond the bar of limitations, *citing Stewart Coach Indus., Inc. v. Moore,* 512 F. Supp. 879 (D. Ohio 1981). We indicated that the limitations questions would likely re-arise on motions for summary judgment, and counsel were alerted to file statements of non-disputed facts pursuant to Local Rule No. 29 as a means of sharpening the concealment issue. To the extent that plaintiff has filed a Rule 29 statement, it is a non-conforming one. Rather than recite material, undisputed facts, it asks a series of argumentative questions, *i.e.,* "What level of expertise can be expected of a former judge (for 20 years)? May he simply defer blindly to other lawyers representing conflicting interests who now disclaim having ever researched the matter, etc.?" One searches in vain for any act of concealment charged by the plaintiff's Rule 29 submission. Creekmore's Rule 29 submission advises that he left the employ of the Co-op on December 31, 1980, and that he last worked on the transaction in question on December 19, 1980. He further says, "At [the Board meeting of December 11, 1980] Creekmore advised the Board that it had been recommended that he file a Complaint on behalf of the Co-op

against Jack White and White Flame Fuels, Inc., and obtain a declaratory judgment on the transfer of the gasohol plant to the Co-op. Creekmore then advised the board of the nature, provisions, and purpose of the proposed lawsuit and the board consented to the procedure." The plaintiff's statement takes no issue with this assertion, but merely questions whether it is true. Under Local Rule 29(c), movant's declarations are deemed to be admitted unless controverted by the defending party within 10 days.

For all practical purposes, the plaintiff has failed to make a showing on concealment at all. Such a showing must be weighty, if the language of *Williams v. Purdy*, 223 Ark. at 279, is to be given any effect:

> There must be some positive act of fraud, something so furtively planned and secretly executed to keep the plaintiff's cause of action concealed, or perpetrated in a way that it conceals itself. And if the plaintiff, by reasonable diligence, might have detected the fraud, he is presumed to have had reasonable knowledge of it.

In plaintiff's brief opposing Creekmore's motion, pp. 2-11, the trustee recites his version of the relevant, material facts very thoroughly. At no point does the trustee suggest that Creekmore did anything *after* December 19, 1980. Rather, to extend the period the trustee *argues* the following: (1) that a conspiracy existed between Creekmore and members of the board to conceal from later board members the facts surrounding the transfer ("Argument" at 13) so that the transfer could be rescinded; and (2) that Creekmore had a duty to advise the Co-op to file a motion to void the decree within 90 days

of its entry, *see* Ark. R. Civ. P., Rule 60(b), for failure of which the applicable limitations period begins running March 19, 1981, or within three years of the date on which the Co-op filed for bankruptcy, an act which extended the limitations period for nonbarred suits, and would presumably save this suit.

The record offers no proof of an agreement between Creekmore and the board members that details should be hidden from members who should later come on board. The court views plaintiff's suggestion that there was such a conspiracy as merely tendentious. After *Celotex Corporation v. Catrett*, 59 U.S.L.W. 4775 (June 25, 1986), a party moving for summary judgment is not required to "support its motion with affidavits or other similar materials *negating* the opponent's claim." Rather, *Celotex* teaches that the non-moving party must "go beyond the pleadings and by her own affidavits, or by the 'depositions, answers to interrogatories, and admissions on file,' designate 'specific facts showing that there is a genuine issue for trial.' " The evidence which the trustee advances to support his contention that there was a conspiracy among Creekmore and certain Co-op directors to conceal Creekmore's negligence consists of the following two statements from directors, both of whom were *not* on the board in December, 1980 (Harris and Willis). Harris declared:

> Q. Before you found the friendly lawsuit at the courthouse, did you ask any of the members that were still – that were on the board back in 1980 how the Co-op had acquired the gasohol plant?
>
> A. Yes.

Q. Do you recall which members you asked?

A. At the board room, and as we talked about it, we were asking anyone, at the same time we were talking about how we owned it. *Anyone would have had the opportunity to have said "Oh I know" if they knew or wanted to give out that information.*

(Harris Depo. at 71).

Similarly, in the deposition of James Buel Willis, the following exchange is found:

Q. . . . did any of the directors that you discussed this with question [the decision to acquire the gasohol plant on February 15, 1980]?

A. *The ones I recall that I talked to didn't know any more about the decree than I did.*

Q. By that you mean they were not even aware of the decree?

A. That's what I understood. I wish I could be more specific on it, but that's my recollection.

(Willis Depo., at 51).

From these circumstances, the plaintiffs appear to infer or argue conspiracy to defraud. (Plaintiff's Brief at 13). It is clear, though, that in Arkansas, stronger proof of conspiracy is needed.[3] In *Fidelity Mutual Life Insurance Co. v. Price*, 180 Ark. 214, 220, (1929), the court noted that "in

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[3] This discussion concerns only a conspiracy to conceal a cause of action for negligence. The court believes that a jury can find a conspiracy to defraud involving Creekmore.

order to establish a conspiracy to defraud, the evidence must do more than excite suspicion; it must *lead to belief.*" (emphasis added). The court said that evidence which was "slight and equivocal" was unsatisfactory for the purpose. In *Fidelity Mutual,* plaintiffs sued to collect on a policy of insurance which had previously been assigned by the decedent to a bank. The evidence showed that shortly after decedent's burial, a family friend wrote to the insurance company and informed it that the decedent owed no debts to the bank (a former judgment having been taken solely *in rem*) and enclosed a copy of the court decree. The bank to whom the assignment had been made was owed a considerable portion of the underlying debt, the judgment property being insufficient to satisfy it. As it happened, the officer to whom the letter was delivered was also a director and stockholder in the bank. The evidence showed that the bank had released the assignment of the policy some time previous to the decedent's demise. Nevertheless, the insurer's officer, Bright, paid the policy to the bank pursuant to the written assignment, and the heirs sued his company and his bank for conspiracy to defraud. In circumstances far more compelling than these here presented, the Supreme Court found there to be no substantial evidence from which conspiracy might be found. The court's reference to evidence sufficient to "lead to belief" is the equivalent of "clear and convincing evidence."[4] In the recent case of *Kelly v. Kelly,* 264 Ark. 865, 575 S.W.2d 672 (1979), the clear and

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[4] Black's Law Dictionary, 5th ed., p. 141, defines "belief" as "a firm conviction as to the allegation sought to be established."

convincing standard was equated with one which produces in the trier of fact "a firm conviction as to the allegation sought to be established." The recent case of *Anderson v. Liberty Lobby,* 54 U.S.L.W. 4755 (June 23, 1986), says that summary judgment may be entered against a party burdened by the clear and convincing proof standard by "consider[ing] whether a reasonable fact finder could conclude, for example, that the plaintiff had shown actual malice with convincing clarity." *Id.* at 4758. In making this determination, the court is not to make credibility determinations, but must believe the evidence of the non-movant, and *all justifiable inferences are to be drawn in his favor. Id.* at 4759. The court does not believe that reasonable jurors could conclude that because two directors were unable in 1982 to obtain information at a board meeting about the chancery court action in 1980, that it follows in any sense that the other directors had conspired with Carl Creekmore to suppress information about how the decree was taken. This airy chain of inference is forged with links of mist. *Anderson* says, at the very least, that one who charges conspiracy must offer some "concrete evidence" and may not "merely assert that the jury might, and legally could, disbelieve the defendant's denial of a conspiracy. . . . " *Id.*

The record, then, discloses no act of *concealment* by Creekmore, nor by anyone else which would properly be chargeable to him. The trustee suggests, however, that Creekmore's failure to advise the board that it could petition the Crawford County Chancery Court to vacate the decree was an additional act of negligence on his part, which continued, according to the trustee, until March 19,

1981, which the trustee argues is the last date such a motion could have been made.

The trustee is here referring to Arkansas Rules of Civil Procedure (ARCP) No. 60, which holds that motions to vacate judgments and decrees can be made for specified reasons up until 90 days after the rendition of the decree. ARCP 60(a). That rule provides that a party can obtain relief from a judgment within 90 days of its entry if the party's motion advances grounds which would have been a basis for such relief under prior law upon a motion made before the expiration of the term of court. Such grounds, prior to 1970, were confined to the grounds for a new trial. *See* Pope's Digest §§ 1536, 1539. These include jury misconduct, accident, surprise, newly discovered evidence, etc., none of which are germane to our inquiry.

Under Rule 60(c)(4) a party may obtain relief from a judgment even after 90 days for "fraud practiced by the successful party in obtaining the judgment." This accords with prior law, which permitted motions to vacate judgments to be filed even after the expiration of the term of court for "fraud practiced by the successful party in the obtaining of the judgment of the court." Pope's Digest § 8246. There is no limitation on such a motion. It could have been brought at any time before or after the term of court under the old rule, or, under the new rule, before or after 90 days.

The question now becomes whether an attorney who *negligently* represented his client in such a way as to allow an opposing party fraudulently to obtain a judgment against his client can ever successfully plead the

statute of limitations to bar an action of negligence brought against him. Theoretically, according to plaintiff, he never could. A remedial step lies always within his power to initiate. This, of course, assumes that he becomes *aware* that a fraud was practiced on his client after the judgment was obtained. Under the rule of *Williams v. Edmondson*, 257 Ark. 837, 520 S.W.2d 260 (1975), the plaintiff must show knowledge of the wrong done, acquired after its commission, in order to argue that the statute should be tolled because of failure to remediate. This record is barren of any suggestion that Creekmore learned of his alleged "negligence" in having obtained the decree, and failed thereafter to inform his client of steps which could have been taken to undo the damage caused by the chancery court judgment.

For the above reasons, then, summary judgment will be entered in favor of Carl Creekmore against the trustee on all claims of negligence. The court finds that they are barred by the applicable statute of limitations, and that the trustee has submitted no proof of any act of concealment chargeable to Creekmore that would bring his action for negligence beyond the bar of limitations.

II. Fraud

Creekmore urges that the action for fraud and deceit, too, be barred by limitations. Such act was, also, one governed by the three-year limitations period established by Ark. Stat. Ann. § 37-206. *Hughes v. McCann*, 13 Ark. App. 28, 31 (1984). Instead of running from the date of the fraudulent act or misrepresentation, however, the limitations period is not tolled until the injured party could

have discovered the fraud in the exercise of reasonable diligence. *City National Bank v. Sternberg,* 195 Ark. 503, 114 S.W.2d 39 (1938). In cases of fraud involving attorneys and fiduciaries, failure to discover the facts constituting fraud is more easily excused. 37 Am. Jur. 2d *Fraud and Deceit* § 409 at 555.

A "fiduciary relation" exists between an attorney and his client, requiring the attorney to act in the utmost good faith. The lawyer must not only not misrepresent any facts to his client, but there must be an entire absence of any suppression of facts within the attorney's knowledge which might influence the client. The burden of establishing the fairness of the transaction is on the attorney. *Chavis v. Martin,* 211 Ark. 80, 199 S.W.2d 598 (1947).

The trustee has alleged that Creekmore represented conflicting interests in November and December, 1980; those of Jack White, by whom he had been privately employed to help secure financing for the gasohol plant, and those of the Co-op. The trustee alleges that Creekmore never revealed to the board that he had represented White. The trustee alleges that Creekmore failed fully to advise the board of the "pros and cons" of the transaction. The trustee has shown that Creekmore was on notice as early as January, 1980, that the gasohol plant was a financial disaster waiting to happen. White, however, was undeterred by the dire warnings of bond counsel and determined to "go ahead." He commenced borrowing large sums of money from the Co-op even before February 15, the date when the board supposedly voted to buy the plant. Creekmore never told the board of the information he had acquired that might have influenced their decisions in February, 1980. Thereafter, in November,

1980, when the board voted "officially" to buy the plant, Creekmore raised no demur. He never suggested that White share the losses in any way. His silence can certainly be seen as having been "in aid of" his client, Jack White. Finally, in December, 1980, the lawsuit essentially "fixed the terms" of the transaction: White formally transferred his shares; the Co-op effectually released White on his guarantee and also paid White's note of $250,000 to Citizens Bank. Creekmore was, at the time, a director of the Citizens Bank of Van Buren, an enterprise which stood to profit from the arrangement by having its loan fully paid.

The court feels that there is sufficient evidence upon which a reasonable jury might find, clearly and convincingly, that Carl Creekmore actually defrauded the Farmers Co-op, for the benefit of Jack White and possibly the Citizens Bank, of which he was a director. Where fraud is pleaded against a fiduciary such as an attorney, the rule relaxing the statute of limitations is often invoked to excuse one's failure to discover the facts constituting the fraud. The decree was taken December 19, 1980, and can therefore be said to be the "last act" in a fraudulent scheme spanning nearly a year. The court cannot say that as a matter of fact or law the circumstances of the fraud should have been discovered within two months. Creekmore has cited us to no event or circumstance occurring between December 19, 1980, and February 23, 1981, which would have put the board on notice that it should have scrutinized *his* dealings with the Co-op more closely. In the absence of such a circumstance, it would be plainly arbitrary for the court to hold, as a matter of summary judgment, that the alleged fraud

should have been discovered within 66 days of its completion.

The court will therefore deny Creekmore's motion for summary judgment on the common law fraud claims brought against him by the trustee.

B. THE MOTION OF ATTORNEYS BALL, MOURTON, & ADAMS

E. J. Ball and Ken Mourton, (as well as their then-associate and current partner, Steve Adams,) have asked for summary judgment on Count II, which charges them with fraud, negligence, and conspiracy to commit fraud with respect to the transfer of the gasohol plant to the Co-op. It appears that Ball and Mourton were hired by the Co-op, *via* Jack White, in May, 1977, to represent it in a civil and criminal tax investigation which the IRS had commenced. On September 5, 1980, the Grand Jury charged Jack White with filing a false tax return (2 counts) and conspiracy to file a false tax return (1 count). In the body of the indictment, the Grand Jury asserted that White had been guilty of self-dealing with the Co-op, and that White and Kuykendall conspired to conceal this fact from the IRS. We have had previous occasion, in the discussion of Count I, to suggest that a reasonable Juror could find that this allegation was capable of putting one on notice that White's loyalty to the Co-op was suspect, and that the interests of the Co-op and its fiduciary White were potentially in conflict, at least with respect to matters raised by the indictment.

On November 12, 1980, Ken Mourton appeared at a meeting of the Co-op board to discuss with them his

firm's preliminary findings and recommendations regarding the Government's civil claim for over a million dollars in back taxes. His report was lengthy, taking until lunch to conclude. Mourton left the meeting at this point. When the meeting reconvened, Jack White told the directors that Mourton had advised him that they needed to document their transactions better, and specifically referred them to an alleged earlier determination to buy the gasohol plant from him, a decision which was not reflected in the minutes, or recorded in any other document such as a deed or contract. The board then voted "to buy the gasohol plant." (Ex. 1528) In many respects, this construction of the evidence is the one most favorable to Ball and Mourton, since it suggests that the Co-op board had actually voted at some time before November, 1980, to buy the gasohol plant, a matter highly disputed in this case. The minutes reflect only that the board "voted to buy the gasohol plant." No terms were set, nor was anyone directed to compose any documents of sale setting forth the terms and conditions of the purchase.

A reasonable jury could find that in February, 1980, the board "talked about" acquiring all of White's interest in the plant, but that the motion was tabled at White's suggestion. The plant had not commenced production at that point, and held at least a promise of profitability. If it were able to produce at or near capacity (9,000 gallons a day), White stood to make a considerable profit on his investment. White may therefore have suggested that the question be held in abeyance so that he could monitor the plant's production and thereby "play the odds," dumping the plant on the Co-op if it couldn't make a profit, negotiating a lucrative sale to the Co-op if it made money.

One reviewing the record is struck by the ambiguity of the Co-op's relationship to an investment as large as a gasohol plant. Apparently, such ambiguities characterized the way White and the Co-op did business. One of the thirty-four "overt acts" specified in the indictment charged that White had participated in a venture with a local produce broker named Gunn, and that the two used Co-op facilities. The entity, called Gunn-White Produce paid "rent" to the Co-op, which ordinarily would be fully taxable, being otherwise disqualified from a characterization as patronage-sourced income. White claimed at his trial that he really "represented the Co-op" in the transaction, although there was no documentation for the assertion, and all available documentation (Gunn-White checks marked "rent") pointed to the contrary. This parallel was appreciated by Mourton, who testified in a deposition that when he heard in November that the Co-op had supposedly bought Jack White out in February, he thought to himself that it sounded a lot like the Gunn-White transaction.

There appears to be little support for a finding that the Co-op owned the plant as of February 15, 1980. The earliest indication that the Co-op had indeed bought the plant appears in the November, 1980 minutes. These minutes were absent from the Co-op's record books for several years. It appears that the handwritten originals of all the corporate minutes were collected by Ball and Mourton in preparation for the trial, including the November minutes which had not been typed by the Co-op staff. Undoubtedly, they were kept by mistake, under the impression that the typed copies were at the Co-op available for inspection. In any event, documentation which

would have alerted an auditor to "re-check" the Chancery Court lawsuit was absent from the Co-op, and the significance of that absence and its bearing on the suit is a matter of argument.

On November 25, White asked to have a meeting with E. J. Ball to discuss some Co-op business. He explained to Ball, who may have been unaware of the November 12th vote, that the Co-op lacked documentation for its ownership of the gasohol plant. White wanted to know what method could be used to certify the Co-op's ownership of the plant. Ball suggested that a declaratory judgment action could be filed reciting White's agreement to transfer the shares, and his failure to do so, praying for a judicial declaration that he was obliged to transfer the shares, and had been as of February 15, 1980.

Were the proof to have concluded at this point, we should have little hesitance in deeming it inadequate to prove actual fraud, although an inference of negligence could be drawn, because of Ball's failure to investigate an unrecorded decision to buy from White a $4 million "White Elephant." Even a minimal investigation would have revealed that the Co-op was not bound to bail White out. After the meeting, Hardin sent Ball a draft of a complaint he had prepared which "got everything wrong": the date, the terms, the pay-out, everything. Ball answered interrogatories admitting that he redrafted the complaint. The redrafted complaint has substantially different terms, and is significantly more advantageous to White giving him, outright, $250,000 in benefits which, in the first draft, were contingent on profitable operation of the facility. Ball now denies having amended the complaint. His interrogatories, however, were signed even if

not notarized, and are therefore admissible evidence as a statement by a party opponent. Federal Rules of Evidence, Rule 801(d)(2).

Plaintiffs argue that baneful and fraudulent motives abound for Ball's actions; Ball insists that he was just trying to be helpful. The court is struck by how closely, in many ways, this situation resembles one which unfolded seven decades earlier in the career of Justice Brandeis, when he was a practicing attorney. A party came to him for advice and apparently did not realize that Brandeis' firm represented an interest antagonistic to his. Brandeis counseled him to pursue a course of conduct which the client later had second thoughts about, and wanted to rescind. He levelled charges of fraud against Brandeis, who denied that he did anything more than counsel the individual how best to effectuate the dissolution of his business and the payment of his creditors. The individual's new lawyer had decided that an assignment for creditors was not such a good idea, and challenged Brandeis to reveal just whose interests he thought he was protecting when he gave the initial advice. Brandeis replied: "I should say that I was counsel for the situation." *Hearings Before the Subcommittee of the Senate Committee on the Judiciary on the Nomination of Louis D. Brandeis to Be an Associate Justice of the Supreme Court of the United States,* 64th Cong., 1st Sess., sec. 6926, at 287 (1916).

It is perfectly inferrable that Ball, in the unfortunate but apt phrase of Brandeis, was "counsel for the situation," suggesting an expedient, problem-solving procedure for accomplishing what everybody seemed to want. Such a voluntary service may not be negligent,

although, once undertaken it must be pursued in a diligent, careful, and conscientious manner, particularly where the service was, as here, fully compensated by the Co-op. Such a duty may require minimal investigation, particularly where White's dealings with the Co-op appear to have been conducted at less than arm's length.

Lack of care may also be inferred from the fact that one who counsels corporations and their fiduciaries have to be on the alert whenever there is traffic between the two. To be frank, there appears to be a unanimity of opinion that Jack White was essentially unchecked by anybody at the Co-op: what he said, the Co-op did, and board meetings and resolutions were mere formalities along the way. The Arthur Young accountants realized this: they commented on it in their work papers. (Exhibit 855). A jury may conclude that White, who was *at least suspected* of fraudulent activity *vis a vis* the Co-op, made what should have been a surprising suggestion to Ball who, rather than investigate its *bona fides,* blindly facilitated the perfection of a transaction which dearly cost his other client, the Co-op. Even though we as a society strive to accord to all our citizens the right to be presumed innocent until proven guilty, there are limits to the application of that doctrine. A reasonable jury could well conclude that in any transaction involving White and the Co-op, after the indictment, red flags abounded to those who wanted to see them.

The jury may further conclude that conduct of Ball and Mourton was reckless which, in the context of fiduciary relationships, is all that plaintiffs need to show to submit a claim of fraud to the jury. After the November

25 meeting, Ken Mourton went to Kansas City and conferred with specialists in co-operative taxation and accounting about the "tax advantages" for the Co-op if the transfer could be established as having occurred on or before the date when the plant commenced commercial production. It appears that there were none. Mourton apparently told Ball that this was the case in a telephone call from Kansas City. The reason for establishing an early date for the acquisition of White Flame Fuels by the Co-op had disappeared for all but one party; Jack White, who stood to improve his personal balance sheet considerably if he had documentation to support his non-involvement with the plant. For one thing, his $4 million debt to the Co-op would disappear. Second, if the lawsuit were properly worded, the Co-op stood to relieve him of obligations to pay hundreds of thousands of dollars of loans to local banks. If, indeed, there was any other motive than to benefit Jack White by going ahead with the "friendly lawsuit," the court cannot find it. The lawsuit was plainly *inadvisable* absent that circumstance. Why, a jury may inquire, would a criminal defense attorney subject his client to news stories which would report that his client had "been sued" by the Co-op three weeks before trial started in a case involving his client's course of dealings with the Co-op?

On December 9, 1980, apparently aware that there was no real rush to document the transfer of the plant to the Co-op, Ball took the redrafted complaint, answer, and decree to Creekmore for filing and execution. The evidence would freely permit a reasonable juror to conclude that the transaction was designed solely to benefit White – or at least that on balance the financial benefits to be

gained by him outweighed, in White's mind, the possibly ephemeral effects of bad publicity on the eve of his trial. If the transaction were *that* advantageous to White, one who represented the Co-op's interests would have had to have wondered why it was such a good idea for the Co-op.

Situations such as these are sometimes the unfortunate fallout from acting as "counsel to the situation." Unless one really has a client, one really has no interests to protect, and no real curiosity about the matter. That can be non-negligent, of course; or it can be negligent, reckless, constructively fraudulent or actually fraudulent. The court cannot decide the issue on defendants' motion for summary judgment. In plain words, there is ample evidence rationally to sustain any one of the possible conclusions. This is especially so where one finds that a "sweet deal" was made even sweeter for White by the redrafted complaint, a circumstance for which there is no compelling explanation.

Furthermore, plaintiffs' expert witness, Drew Kershen, has testified that Ball and Mourton were representing conflicting interests. This opinion alone, if not unreasonable, would raise a fact issue incapable of resolution by summary judgment. Generally speaking, an attorney may be liable to his client for losses resulting from the representation of adverse interests. *Rolfstud, Winkjer et al. v. Hanson,* 221 N.W. 2d 734 (1974). An attorney who, even with the consent of the interested parties, represents such adverse interests may be liable for loss sustained by one of them due to the attorney's failure to disclose a material fact. *Johnson v. Andrade,* 54 S.W. 2d 1029 (Tex. 1932). The jury may conclude that a

cursory inquiry by Ball and Mourton would have revealed to them that the Co-op could lawfully disaffirm whatever ambiguous relationship existed between it and the gasohol plant. In such a circumstance, the Co-op might have wanted to investigate anew whether it was a good economic idea to buy the plant at a price which guaranteed White no losses. "Partners" share losses, unless one doesn't watch out. Nothing could have been easier than to have called a special meeting of the board to ventilate all the considerations so important to such a critical decision.

The court would make it clear that this question is not one resolvable solely by reference to the Canons of Ethics. The basis for this civil action is the common law of fiduciary obligations. *Fielding v. Brebbia,* 399 F.2d 1003, 1005 (D.C. Cir., 1968). Whether or not a breach of that obligation has occurred *may* be determined by reference to the standards set forth in the Disciplinary Rules. *Jeffry v. Pounds,* 67 Cal. App. 3d 6 (1977). We interpose this distinction in response to defendants' suggestion that the court make a ruling on the merits since the simultaneous representation of White and the Co-op was not in contravention of the Canons. (Defendants' Reply, Part IV A). Their authority, *American-Canadian Oil & Drilling Corp. v. Aldredge & Stroud,* 237 Ark. 407, 373 S.W. 2d 148 (1963) does not hold, as defendants suggest, that where the questions for decision implicates the Canons, there is never a question for a jury to decide. That would be an odd holding to announce in the context of an appeal from Chancery Court. *American-Canadian's* reference to such questions as being "ones of law" means only that the Canons *do not absolutely exclude* the possibility that a

lawyer might ethically represent parties with nominally opposing interests. If that were the case, Aldredge and Stroud would have had to have surrendered their fee with no further inquiry. The court said, however, that "[t]he primary question for determination is whether the attorneys did, *either in fact or as a matter of law,* represent conflicting interests. . . . " *Id.*, at 409. Inasmuch as Aldredge and Stroud's representation was not excluded as a matter of law, the court then made a factual inquiry to determine whether, *in fact,* the interests were in conflict. The decision recognized that the existence of a conflict is primarily a factual question. In this case the inferences to be drawn from the facts are competing and far from clear.

An attorney may represent two parties where "it is obvious" that their interests do not conflict. A jury may decide that it was not at all "obvious" that the interests of White and the Co-op were in harmony. They may then proceed along further avenues of inquiry. The Code does not indicate how "clear" a conflict must be in order for dual representation to be impermissible. The court infers from this that the community, as embodied by the jury, has a role in deciding such questions, bringing to bear their own experiences in life.

This inquiry, as we have suggested, may support a finding that Ball and Mourton were reckless. This permits an inference of fraud: as a matter of law, in fiduciary contexts, where a finding of recklessness may be made, a question of fraud *has* to be submitted to the jury. A finding of actual fraud by the jury would render moot any reliance on the formalistic propriety of the activities in question under the Canons of Ethics.

A finding of fraud based on evidence of recklessness would also permit the jury to conclude that the defendants conspired with others to damage the Co-op. Moody, in his motion for summary judgment, correctly pointed out that one cannot recklessly join a conspiracy. We hold that to be undoubtedly true. Recklessness in a fiduciary relationship *permits* but does *not require* a finding of fraud. The jury may find recklessness and decline to find fraud. Fraud is a matter of positive intent, a subjective and interior mental attitude rarely capable of direct proof. Permitting the inference to be made on evidence which, in a non-fiduciary context, would not otherwise suffice, simply recognizes the distinctiveness and the importance of the context. Collaterally, it has the effect of reinforcing the fiduciary's duty to handle his ward's affairs with care. Simply stated, the law demands more of fiduciaries.

If the jury makes the permissible leap from recklessness to fraud, there is no impediment against their finding a conspiracy to effect it. The parties to this transaction worked quickly and in co-ordinated fashion, pursuant to an agreement. In this case, the "agreement" to formally document the transfer of the gasohol plant to the Co-op by concerted action exists and is admitted by all. The argument is whether the agreement was intended for ill or not. There can be no question but that Ball advised the procedure, and that Creekmore consented to effectuate it. Depending on their intent, the agreement was either innocently, negligently, recklessly, or fraudulently made. Either of the latter two findings will permit the jury to conclude that the suit was the product of a civilly actionable conspiracy. It is not necessary that a civil conspiracy

be proved by direct evidence. "That some links in the chain of conspiracy. . . . to defraud have been forged from circumstantial evidence, and in the fact of a flat denial thereof by one of the defendants, does not weaken the finding of the jury." *Johnston v. Andrade, supra,* at 1030. In most cases, conspiracy counts are dismissed because of an absence of evidence that parties acted pursuant to an agreement. Here an agreement of some kind is admitted. We therefore believe that plaintiffs may submit this case to the jury against Ball and Mourton individually, as joint tortfeasors, and as conspirators.

In conclusion, summary judgment will be denied Ball and Mourton on their motion in opposition to Count II of the Consolidated Complaint. As we have stated in response to Creekmore's motion, the fact that more than three years passed since the conclusion of the alleged fraud in transferring the gasohol plant to the Co-op does not necessarily absolve them by a plea of limitations, since a more relaxed rule is involved in cases wherein fiduciaries are said to have defrauded their wards. The defendants will be permitted, evidence allowing, to submit instructions asking that the jury consider the limitations defense, the defense of ratification, or any other matter upon which the evidence permits a finding. It would be plainly arbitrary for the court to declare that the White-dominated Co-op Board should have discovered the alleged fraud within sixty-six days of its completion, or that any Co-op shareholder should have discovered the "true" state of affairs and commenced a derivative action.

A more vexing question is presented with respect to the negligence claims against Ball and Mourton, or for

findings of recklessness in the absence of fraud. A single consideration prevents our granting summary judgment on those claims. The Arthur Young auditors sought information about White Flame and sent a letter to Ball and Mourton, asking for data relevant to their audit. Mourton responded, saying that the only thing Ball and Mourton knew about White Flame Fuels, Inc. was that it was being audited for 1980.

Creekmore, as we have said, did nothing after his term of employment with the Co-op that concealed in any way any possible negligence on his part. We are furthermore of the opinion that one loses his right to the repose promised by the statute only where he fraudulently and knowingly conceals his former negligence. We are frankly hesitant to permit the plaintiffs to proceed on a theory of negligence or mere recklessness against Ball and Mourton, but are not satisfied on the state of this record to grant the summary judgment. For one thing, the letter was, in a sense, untrue: Ball and Mourton did know that White Flame was allegedly purchased by the Co-op in February, 1980, a fact which, if given to the auditors, would cause a number of problems, if only for Arthur Young. Furthermore, Mourton in his affidavit did not explain the letter, and Ball's affidavit refers to (but does not produce) a letter from White which would otherwise put Mourton's response in context. Because it is possible, in a fiduciary context, for a failure to disclose to be fraudulent, Mourton's letter may not have "disclosed enough" to survive a plea of tolling on a motion for summary judgment. The court may be willing, at the conclusion of the evidence, to take this question from the

jury, but frankly hesitates to do so now, in the absence of a firmer conviction, supported by the record.

Finally, Steve Adams' motion for summary judgment is granted, not only as to this count, but as to all others. His liability for the acts of Ball and Mourton extends only to his interests in the partnership, except for those damages legally chargeable to the firm after January 1, 1982.

IV. Count III: Securities Fraud in Transferring White Flame Stock To The Co-op

The Consolidated Complaint charges Ball and Mourton, and Carl Creekmore, with securities fraud in connection with the transfer of the shares of White Flame Fuel to the Co-op. As we mentioned in our opinion on the motions to dismiss, *Robertson v. White*, 634 F. Supp., at 969, this cause of action may be pursued only by the "buyer", i.e., the Co-op.

Ball and Mourton argue that the state securities law complaint should be dismissed as to them because they were not "controlling persons" under the statute; because they had no knowledge of any untruth or omission with regard to the transfer; and because they did not materially aid the transfer, or otherwise act recklessly. (Ball and Mourton, Motion for Summary Judgment, Brief, p. 32).

Ball and Mourton argue that it is undisputed that the transfer of the gasohol plant happened before the November 25th meeting with White during which they merely suggested a way by which the transaction might-properly be memorialized and documented as having

occurred on February 15. Consequently, they suggest there can be no securities fraud chargeable to them because the transaction was final for all intents and purposes before they did anything. Their function, the argument goes, was merely clerical, and if vulnerable to attack for that reason, could only be redressed under common law counts for negligence and fraud, whose elements and damages differ from those permitted under the Arkansas Securities Law.

First, as the court has had occasion to observe, in connection with our opinion denying plaintiffs leave to amend their complaint, *Robertson v. White*, CIV-86-2044 (W.D. Ark. slip op. May 16, 1986) it is extremely doubtful that a jury would find that Jack White parted with his interest in the gasohol plant on February 15. He continued to make sworn representations to all and sundry that he owned the plant. In any event, the evidence on that point is such that a reasonable jury could find indeed that no decision had been made by the Co-op board to buy the plant.

Second, as we have observed, the minutes of the November 12 board meeting say only that the board voted to buy *the gasohol plant*. No terms were specified, and a jury can find that no contractual obligation existed which bound the Co-op to do anything at all. Furthermore, the minutes reflect that the Co-op board voted to buy *the plant*, not the stock of White Flame Fuels, Inc. One can buy all of a corporation's assets, and none of its stock, and thereby avoid securities laws problems. As Mr. Justice Stevens dissenting in *Landreth Timber Co. v. Landreth*, 53 LW 4602, 4607 (1985) said "[i]t is only a matter of interest to the parties whether the transaction takes the

form of a sale of stock or a sale of assets," a circumstance from which he argued that the Federal securities law should not apply to sales of a business involving transfers of stock. In Justice Stevens' mind, securities questions could be avoided entirely by a contractual provision in which the buyer would elect to buy all the assets of a corporation, and none of its stock. The court majority, however, applied the "plain language" of the federal securities statute, which by its own terms governs the sale of "any security," including "stock."

Under this analysis, it may very well be that it was Ball and Mourton alone who were responsible for introducing "securities issues" into the situation. It is very doubtful, viewing the record in the light most favorable to the *moving* party, that a jury would find that the Co-op board had voted to buy White Flame's *stock*. We do not therefore accept the suggestion that a securities transaction had been completed before November 15, 1980, even if the Co-op were contractually bound to "buy the plant," a matter which is highly disputed.

Defendants also suggest that Ball and Mourton were not controlling parties of Jack White, and were not employees of White Flame who "materially aided" the sale of the security. An attorney for a seller of securities can be considered a controlling party if he assists in preparing circulars or opinion letters containing incorrect information. *SEC v. Frank,* 388 F. 2d 486 (2nd Cir. 1968); *SEC v. Spectrum Ltd.*, 489 F. 2d 535 (2nd Cir. 1973); *Felts v. National Accounting Systems Associates, Inc.*, 469 F. Supp. 54 (N.D. Miss. 1978). Such a level of assistance is not materially distinguishable from that alleged to be present in this case, *i.e.*, preparing all the documents for the

transaction, and designing it in a way so as to implicate the securities laws.

In addition, the state securities act enumerates the parties against whom purchasers *may* prosecute an action. The law does not purport to say that such parties are the *only* ones who could be responsible under the law, since such a limitation would conflict with its broadly remedial purpose. Indeed, Ark. State. Ann. § 67-1256(h) asserts that the rights granted under the law are in *addition to* others which exist in law in equity. Rights against joint tortfeasors are established by law, and extend beyond the principal actor to embrace parties who advise or encourage him to commit a particular act, *see generally, Lewis v. Mays*, 208 Ark. 382, 186 S.W. 2d 178 (1945), or those who, having a duty to speak out, remain silent. We believe that a reasonable jury could conclude that Ball and Mourton are liable under both statutory and common law theories. Defendants also argue that they have established the good faith defense set forth in Ark. Stat. Ann. § 67-1256(b). The court believes that a jury question has been made out on that issue, as well.

The lawyer defendants also protest the legal sufficiency of actions brought against them under the Federal securities laws. They argue in this connection that since they did not sell the White Flame securities, their liability is limited to "aider and abetter" liability, which requires the existence of a primary violator (*e.g.*, White), knowledge of his violation, and substantial assistance. For reasons discussed generally before, the evidence will permit an inference that Ball and Mourton owed a duty to the Co-op as its own lawyers in the transfer of White Flame shares to it. Although the proper delineations of who

represented whom are lost in the murky depths in which one sometimes finds himself when he undertakes "to counsel a situation," plaintiffs argue that at his deposition Mourton said he believed that the firm was representing the Co-op: If that was the case, the firm owed duties to the Co-op relative to the transfer, even though such duties were otherwise beyond the original scope of their representation.

As we have mentioned, a jury may infer recklessness, given that Ball and Mourton gave credence to parties who could not document a highly questionable assertion, and who appeared to be ready to accomplish their goal by a means which Mr. Ball thought clearly fraudulent (back-dating the stock). One of the parties at the meeting (White) stood accused of self-dealing; another (Brewer, Chairman at the Co-op board) was an unindicted co-conspirator; and the third, Creekmore, was absent from the February 15 meeting at which the deal was allegedly struck, and was in no position to confirm or deny details. Ball and Mourton cannot claim that Creekmore clearly misled them at that time, at least for purposes of summary judgment, since Creekmore denies being present at the November 25th meeting. This is all a very long way of saying that this matter cannot be concluded on summary judgment. The court declines to repeat, again, all the facts and circumstances from which a jury can infer recklessness, or fraud. Suffice it to say that plaintiffs have made a jury question on *scienter.*

The court believes, also, that plaintiffs have proved substantial assistance. Defendants admit counselling the means by which the transfer would take place, supervising the preparation of the documents, and delivering

them for ultimate approval by the Court, as well as counselling that the interests to be transferred be specified as securities. It appears on the face of the record, from defendants' admissions, that their input was the *sine qua non* of a securities transaction, and the only real question appears to be *scienter,* which as we say is subject to conflicting inferences.

That which we have asserted with respect to Ball and Mourton's motion applies as well to Creekmore's. The inference of *scienter* is much stronger in his case, since he presumably knew, far in advance, that the gasohol plant was an unwise investment, and concealed that fact from the Co-op, suppressing the bond offering statement which was intended to have been read by the directors before approving an investment in the plant. If that information was relevant for a decision to buy bonds, it was relevant for a decision to buy stocks. Furthermore, Creekmore substantially assisted the transfer by acting as Co-op counsel in the suit, and procuring the decree. His motion for summary judgment on Count III will also be denied.

We believe, therefore, that plaintiffs may present to the jury a claim for securities fraud and conspiracy against Ball and Mourton, and Carl Creekmore, in connection with the December 19, 1980, transfer of shares in White Flame Fuels, Inc., to the Farmer's Co-op. Inasmuch as the statute of limitations under the state and federal acts is five (5) years, questions on that defense will not be submitted to the jury.

V. COUNT IV: NEGLIGENCE AND FRAUD IN ALLOWING THE CO-OP TO CONTINUE IN OPERATION AFTER INSOLVENCY

Count IV survived motions to dismiss directed against both the class and the trustee. At the time of our rulings on the motions to dismiss, the contours of the rights severally asserted by the Co-op trustee, and by the class, were not known. Now that the record is cleared, the court can proceed to adjudicate the motions directed against these causes of action. The count alleges that the directors, lawyers, and accountants wrongfully prolonged the operation of the Co-op, deepening its insolvency, and rendering its creditors less secure. The complaint asserts that this cause of action is based on one filed by the Superintendent of Insurance in *Schacht v. Brown*, 711 F. 2d 1343 (7th Cir. 1983). That action, in its turn, found its moorings in Illinois corporate law, and statutory law governing insurance companies. *Id.*, at 1345.

The common law of Arkansas does not recognize a separate tort of "managing an insolvent corporation." We believe, in fact, that very few jurisdictions hold to such a view any longer. Some jurisdictions early on held that it was *prima facie* fraudulent for a director of an insolvent corporation, knowing its true condition, to accept an extension of credit, *see Cassidy v. Uhlmann*, 170 N.Y. 505, 63 N.E. 554 (1902). Such views were not uniformly held in America, *see e.g., United States Fidelity and Guaranty Co. v. Corning State Sav. Bank*, 154 Iowa 588, 134 N.W. 857 (1912). The *Cassidy* court reasoned that when, by virtue of fraud or *during insolvency,* a corporation accepted credit from another party, the ordinary relation of debtor and creditor

did not arise. Instead the directors of the corporation became trustees *ex maleficio* for the creditor because "title" to the money never passed. *Cassidy* declared, in effect, that the relation of trustee and *cestui que* trust came into existence, giving creditors direct rights of action against the directors of insolvent corporations, as more than one such officer, including Uhlmann, discovered in the aftermath of the Depression of 1893.

Such views as *Cassidy's* are decidedly antique. Nineteenth century courts were not always friendly to the corporate fiction, and the political atmosphere of the Populist era, particularly as it expressed itself in legislation, did little to ease that hostility. In Arkansas, for example, corporations were required to file annual financial reports in the courthouse. If they did not, directors became personally liable for all corporate debts even in the absence of reliance or misrepresentation. Kirby's Digest of 1904 § 848. *See, e.g. Hughes v. Kelley Bros.*, 95 Ark. 327, 129 S.W. 784 (1910). *See also*, "The Wingo Act," Ark. Stat. Ann. § 64-1202 (1980 Repl.)

As the corporate form and the society within which it existed matured, restrictive policies disappeared, and a more neutral view of incorporated entities became prevalent. In 1965, Arkansas passed its variant of the Model Business Corporation Act, a compendium of statutes more liberally inclined towards management than the codes which had preceeded it. The Act is this state's organic law of corporations, and governs the relations among the various interests implicated in a corporation – officers, directors, shareholders, and to some small extent creditors.

We believe, upon reviewing the Act, that it repudiates the kind of analysis which made the continuing management of an insolvent corporation tortious *per se* against creditors and investors. For example, whereas older courts may have made directors "trustees" for creditors, the Arkansas Act says: "the directors of a dissolved corporation should not be deemed to be trustees of its assets. . . . " Ark. Stat. Ann. § 64-904(A)(i). While this section of the Act ought not be interpreted expansively, we believe that it is at least expressive of a notion that corporate directors are not to be considered fiduciaries for "the world," a view towards which older cases such as *Jackson v. Lockling,* 88 U.S. 616, 624 (1874) inclined. If directors are not to be deemed trustees when a corporation is in liquidation, a process not always supervised by a court, there seems to be little support for a notion that the Arkansas common law would impose a trust on them while the business was still conducting its affairs, even though insolvent.

This is not to say that directors or third party professionals owe no duties to the shareholders or to that part of "the world" which extends business credit to a corporation. Rather, the duties owed exist independently at common law – *i.e.,* the duty not to be negligent, not to be fraudulent – and knowledge of insolvency is only *a* factor to be considered in determining the scope of the duty and the extent of the liability.

For example, in *Shapiro v. Glekel,* 380 F.Supp. 1053 (S.D. N.Y. 1974) a bankruptcy trustee brought an action against an accounting firm which had formerly been employed to audit a company's books. The trustees charged that the accountants had negligently failed to

detect inaccuracies in certain financial statements, and that the corporation was thereby allowed to overstate its earnings and financial condition, leading the directors to engage in an ill-advised series of acquisitions. The trustee claimed that the accountant's errors caused the firm to declare bankruptcy. Significantly, the accountant defendants claimed that the top officers of the company knew that the statements were inaccurate, which, they argued, should have estopped the trustee from asserting the auditors' errors as cause for damage; the defendants also argued that the corporate entity was, on the evidence, contributorily negligent as a matter of law. Such a finding, in New York law at the time would have barred recovery.

Shapiro held that the correct rule for contributory negligence applicable in accountant's liability cases is that the negligence of the employer is a defense only when it has contributed to the accountant's failure to perform his duties and to report the truth. *Id.*, at 1058. We believe that to be the correct statement of the law. While it is true that a director's knowledge may be imputed to the corporation, that rule does not apply where the director, or agent, is acting contrary to his master's interest, or in pursuit of his own. In the context where a professional auditor is retained, a law which would shield an auditor from liability in such cases would hardly encourage accountants and auditors to determine the most accurate and reliable data. The auditor's role in our society would be effectively undermined if he suffered no liabilities to his client for a negligent assay of financial statements because the knowledge of "a director" forecloses recovery. A duty to report truly and carefully should be

enforced against auditors if for no other reason than that, on the least chance, there might exist one member of a board who cared or who took his duties seriously.

It hardly speaks well of a profession that it can take a fee from an enterprise managed by persons whom it knows to be unsophisticated ("Farmer's Co-op's Board of Directors and Management Team: Do they have the capability to keep the Co-op afloat? Fred Howard – Yes. The Directors – you know *them,* what do you think? AY work papers, No. 11405 [emphasis added]) and perhaps even insouciant, and that it can defend its own negligent performance because it suggest that the directors knew that the unstated problems existed. That appears to be Arthur Young's defense. (Memorandum, August 14, 1986, pp. 9-11).

We believe that a reasonable jury could find that under the particular circumstances of this case Arthur Young's performance was negligent. Some of these circumstances are: (1) the presence of a multi-million dollar enterprise, receiving investment capital exceeding $10 million; (2) management so naive as to be the subject of deprecatory comment in the auditors' work papers; (3) a financial situation sufficiently precarious as to earn the professional sobriquet "Close Monitoring Client"; (4) a history of "related party transactions" so outrageously extreme that the principal beneficiary of Co-op "gifts," Jack White, is emboldened to demand $82,500 from the co-operative as recompense for a "contribution" he admittedly made many years ago (AY 11513); (5) the presence of a "nonproducing asset", in the form of a gasohol plant, the very existence of which is an albatross around the Co-op's neck, and the acquisition of which

was just one of a series of "related party transactions" which seemed, for some reason, solely and consistently to benefit one person. In the circumstances, the "auditors" had the choice of writing down the gasohol plant to its net realizable value, and really getting people's attention, or maintaining and even to a certain extent *inventing* a fiction that the plant belonged to the Co-op since 1979! This "hypothesis" allowed the auditors to carry the asset on the books at its cost, $4.5 million, rather than its worth, perhaps $750,000, and therefore gave the Co-op the appearance of solvency. In September, 1982, four months after this artificially roseate audit was presented, the Co-op board, not having had their attention aroused, entered a contract with Jack White to operate the gasohol plant, promising him "half the profits." Mr. White was astute enough not to make a profit from the operation of "White Flame Fuels." He sold the grain used to make gasohol, at a loss, to his new business, Valley Feeds. Valley Feeds sold the grain at a profit.

The court believes, under the rule of *Shapiro v. Glekel, supra,* that a reasonable jury would be justified in finding that the Arthur Young accountants did not proceed through their engagement as reasonable men would do. They would be entitled to find that certain damages were proximately caused by their lack of care. *Id.*, at 1058-59.

In short, although we do not believe that the operation of a business during its insolvency is *per se* negligent or wrongful, we believe that insolvency and its perception is a very important circumstance to keep in mind when one gauges the duties owed by an auditor to his client. It is a sign that says "thin ice." It will ultimately be

for the jury to decide whether the auditors behaved reasonably, in light of all the circumstances.

Context is also important in determining whether the auditors behaved recklessly. As we have said with respect to the attorneys, lawsuits do not rise or fall on the question whether a given ethical canon was observed or violated. Those canons are guides for the jury in making ultimate determinations. Similarly, auditing standards and accounting principles are helpful to a jury in determining whether the accountants comported themselves as reasonably competent professionals or whether they departed grossly from that standard. A finding of actual fraud by the jury renders an *arguable* compliance with standards moot; a *good faith* compliance with the standards, however, makes a finding of fault impossible.

In reviewing the motions for summary judgment, the court believes that a jury might reasonably find that Arthur Young's audit report was dictated by the *result* it wished to achieve, for whatever reason. Plaintiffs have suggested that the accountants did not want a reputation fro being too punctilious, or wanted to keep the Co-op's business, or maybe wanted to cover themselves for having testified on behalf of White and Kuykendall in the 1981 criminal trial. The court is uninterested in the *motive*, except to suggest that plausible ones have been advanced.

The record may permit a reasonable jury to find that the auditors adopted a blatant fiction – that the Co-op owned the entire plant at its inception in May, 1979 – in order to justify carrying the asset on its books at its total

cost, as if the Co-op had built it from scratch. The auditors indulged this fiction despite being aware of the Chancery Court decree which said that it assumed ownership of the plant in February, 1980, at a time when it was substantially completed. The auditors also had reviewed contracts and other documents showing that Jack White and Edwin Dooley jointly started the plant in May, 1979, and that White bought Dooley out six months later, taking an assignment of all of Dooley's stock. An investigation would have revealed to them that the minutes of the February 15, 1980, meeting of the Co-op board, during which the $4 million plant was allegedly "purchased," were completely silent on the point. Furthermore, audits for 1979 would never have shown that the Co-op owned the asset or claimed to have had any interest in it. A reasonable jury could conclude that the Arthur Young defendants picked an acquisition date out of the air that they could "justify," in order to record assets onto the books in a way that would make White's management "look better."

A reasonable jury could find from the evidence that when this decision was made, the cost figure given the asset was essentially invented. The Arthur Young accountants have testified that they "independently" arrived at a figure for the "cost" of the gasohol plant that matched, *to the penny,* the figure assigned by convicted felon Gene Kuykendall in his audit for White Flame Fuels. If Mr. Kuykendall had audited White Flame for 1980 in accordance with generally accepted accounting procedures and auditing standards, such a congruity of result in a similarly conducted "independent" review would not be remarkable. However Kuykendall testified

in a later deposition that he essentially "got up" a figure for White Flame overnight a few months after his conviction. He took *all* the moneys spent on the plant, and arbitrarily capitalized 80% of these and expensed the rest. Not only that, Kuykendall, realizing that snooping revenue agents might become suspicious if items were expensed at 20% across the board, cleverly juggled the figures so that certain categories of expenditure were expensed at a rate of 23%, others at 18% or 19%. He candidly admitted that expenses were figured at 20%, because otherwise the gasohol plant would have shown "a tremendous big loss" for 1980. That would not have been very pleasant for his friend, Jack White, who hung the albatross around the Co-op's neck at the end of that year.

A reasonable jury would be justified in concluding that Arthur Young did not independently arrive at Kuykendall's figure, and that the odds against their having done so were astronomical. A reasonable jury could find that Arthur Young had no actual belief in its audit report: either in the cost figure at which to record the gasohol plant or in the fiction which they employed to justify carrying the asset at cost. A reasonable jury could conclude that the determination to carry the asset at cost rather than value was critical to the presentation of the Co-op as "a going concern." A reasonable jury could conclude that a determination not to write the plant down to its "net realizable value" effectively delayed the reorganization of the Co-op for two years, and that furthermore this was a foreseeable consequence of that decision. A reasonable jury could conclude, under the

authority of *Shapiro v. Glekel, supra,* that this decision proximately resulted in damages to the Co-op.

Unlike *Shapiro,* a jury in this case could reasonably conclude that Arthur Young's conduct was fraudulent. *Ultramares Corp. v. Touche,* 255 N.Y. 170, 174 N.E. 441 (1931) held that an auditor cannot be liable in negligence to one not in privity with him, such liability groundable only in fraud. The court defined fraud for such purposes as follows: "Our holding does not emancipate accountants from the consequences of fraud. It does not relieve them if their audit has been so negligent as to justify a finding that they had no genuine belief in its adequacy . . . " *Id.,* at___. Later, in *State St. Trust Co. v. Ernst,* 278 N.Y. 104, 15 N.E. 2d 416 (1938) the same court said: "A representation certified to be true to the knowledge of the accountants *when knowledge there is none,* a reckless misstatement, or *an opinion based on grounds so flimsy as to lead to the conclusion that there was no genuine belief in its truth,* are all sufficient on which to [find fraud]." (emphasis added). The court believes, especially given the context in which Arthur Young's services were rendered, that a jury would be amply justified in finding that the accountant's audit report was a fraud on the Co-op Board, whose members have repeatedly testified that they relied on skilled professionals to give correct and reliable advice.

A finding of fraud would also enable members of the class to protest that they bought notes, or refrained from cashing theirs in, on the reasonable belief that the Co-op was solvent. However, in Arkansas, common law fraud claimants must prove that they *specifically relied* on a given representation. *CF. Higgins v. Hines,* 289 Ark. 281,

283-84, 711 S.W.2d 783, 784 (1986). The record does not permit a finding of the specific kind of reliance required by the common law precedents in this state or others. The history of the action of fraud is such that one must show that a given misrepresentation was material, and that it induced the transaction or forbearance complained of. In the *patois* of securities lawyers, fraud plaintiffs must prove "transaction causation" as well as "loss causation."

The common law of fraud has its own logic and policies, and exculpates the unscrupulous who are fortunate enough to con the extraordinarily gullible. That is, if a defendant can prove that his misrepresentation was "too outrageous" for reasonable belief, then he can defeat a common law action. *Prosser and Keeton on Torts*, 5th Ed., § 108, pp. 749-750, *citing*, *H. Hirschberg Optical Co. v. Michaelson*, 95 N.W. 461 (Neb. 1901).

The foregoing is set forth to demonstrate the recalcitrance of the common law of fraud and deceit to new theories in which elements such as "reliance" are capable of being presumed. In the common law world, it is still very much dog-eat-dog. We have seen no inclination from the Arkansas courts that they are willing to abandon fraud's traditional focus on the plaintiff's reasonable reliance in favor of a system of liability which seeks to deter all deceitful conduct.

As we shall have occasion to see, however, the securities laws of the state and federal governments have been drafted with a different purpose in mind, *viz.* the protection of investors. In a context in which by its very nature one parts with money, to be controlled by another, with the expectation of profit to accrue thereby, the legislatures

have shifted their focus so as to encourage full and accurate disclosure of investment information. Capital is a precious resource. Squandered, it is useless. Governments have an interest in seeing to it that legitimate and profitable businesses do not have to compete on an unfair basis with unscrupulous enterprises for the attraction of capital. Therefore disclosure laws are enacted to redress the competitive imbalance that can exist without redress under the common law. Simply put, a series of rules that emerged out of warranty two centuries ago in the case of *Pasley v. Freeman*, 100 Eng. Rep. 456 (U.B. 1789) are inappropriate for broadcasts to an extensive investor community whose responses to the same information are bound to vary according to temperment and other individual characteristics. In such a circumstance, it is only sensible, given the policies of the government to encourage a rational allocation of capital resources to shift the focus of a legal inquiry away from the many individual buyers and sellers, and onto the relatively few promoters. This shift in focus will justify the imposition of liability onto Arthur Young for violation of the securities laws, as we shall see, *infra*.

Finally, the plaintiffs have charged that there was a giant conspiracy among all or part of the defendants to maintain the Co-op through insolvency. Such a hypothesis "explains" a lot. However, there is no evidence for it. We could at greater length explain our conclusions in this regard; we believe, however, that such examinations are more appropriate in cases where plaintiffs offer *some* evidence in support of their assertions, or where they inform the court who, of all the defendants, engaged in the conspiracy. Simply stated, the charge of conspiracy

lacks any factual support. We do not think it wise to expose late arriving defendants such as Arthur Young to millions of dollars of pre-existing losses unless there is some evidence to support an inference that Arthur Young, in essence, bought into White's programme of frauds against the Co-op. If there were evidence of such an agreement, we would not hesitate to submit the matter to a jury. We are firmly convinced, under the reasoning of *Anderson v. Liberty Lobby, Inc.*, 54 U.S.L.W. 4755 (1986); *Mitsushita Electric Industrial Co. v. Zenith Radio Corp.*, 106 S.Ct. 1348 (1986); and *Fidelity Mutual Life Insurance Co. v. Price*, 180 Ark. 214 (1929), that no triable issue of conspiracy is presented under this count against any of the defendants.

Furthermore, there appears to be no issue under this count with respect to Ball and Mourton, or Carl Creekmore. The only acts alleged against Ball and Mourton relating to events happening in 1982 are that they continued representing White through his appeal and sent a single letter to an auditor. We have suggested that the letter may toll the statute with respect to earlier negligence, but we decline to find that it constitutes grounds for an entirely new cause of action. Summary judgment will be entered in favor of the lawyers and accountants on theories of conspiracy, and in favor of the lawyers with respect to allegations of fraud and negligence asserted in connection with the Co-op's operation through and beyond insolvency. Summary judgment is being denied on the Trustee's complaint that the performance of the auditors negligently or fraudulently caused damage to the Co-op.

VI. COUNT VI: ACTIONS UNDER STATE AND FEDERAL SECURITIES LAWS CLAIMS.

Defendants have moved for summary judgment on the class's state and federal securities law claims. These claims seek to hold the lawyers and the accountants liable for the sale of unregistered securities, as well as for issuing securities by means of fraudulent misrepresentations of the Co-op's financial status. We have reviewed, in our discussion of Count IV, the basic statement with which the plaintiffs take issue: that the Co-op was solvent, when in fact it had a negative net worth and a horrendously low current ratio. The plaintiffs allege further as against the Arthur Young defendants that they permitted employees of the Co-op to "condense" the audit report so as to exclude any of the accountants' explanatory notes. These notes warned, for example, that there was "some doubt as to the recoverability of the investment in the gasohol plant." It appears to be concededly true that an audit report issued without such a qualification would mislead a reader.

It appears from the record that the Arthur Young accountants met with the Co-op board to discuss their 1981 and 1982 audit reports in the spring of 1982 and 1983. They answered questions from the board, and agreed, for a fee, to address the annual meetings of the shareholders to be held a few weeks later. At these annual meetings, which were widely attended, the Arthur Young accountants were introduced to the membership as the Co-op's auditors. They then reported on the previous years' operations and presented a summary of the Co-op's assets and liabilities. These summaries did not

inform the membership that the gasohol plant was being carried on the books at cost. Instead, the members were told that a complete report was available for inspection "in the office." In addition, the Co-op mailed a monthly newsletter to its membership. This newsletter advertised the attractive rates of interest offered by the Co-op's demand note program and contained balance sheet information primitively styled "What You Own" (Assets) and "What You Owe" (Liabilities).

The information telling the Co-op member "what he owned" included the inflated cost basis report of the gasohol plant. Co-op members were continually reassured that the Co-op's million-dollar equity made investments in the demand note program "safe . . . secure . . . and there when you need it." In fact, plaintiffs say, the Co-op was deeply insolvent for nearly two years before its bankruptcy.

At the shareholders' meetings themselves, the membership were given financial statements "condensed from Arthur Young and Company's Audit Reports." These condensed reports were not qualified in any manner. They carried the gasohol plant at an expressed valuation of $4.5 million, when in fact it had a value, for scrap, between $500,000 and $750,000. The membership were advised that they had a total members' equity of $2.6 million as of the end of 1981 and $1.4 million as of the end of 1982. The court understands that a jury may find that Arthur Young's representatives simply read the condensed statements to the shareholders, without elaboration or qualification, even though the statements, without qualification, were admittedly misleading. With these matters in mind, we will proceed to study the state and

federal nonregistration and misrepresentation claims against the lawyers and accountants.

A. NON-REGISTRATION CLAIMS

The court has previously held the Co-op demand notes to be "securities" for purposes of the Arkansas securities laws requiring registration or exemption. *Robertson v. White,* 635 F. Supp. 853 (W.D. Ark. 1986). We did not then decide whether the notes were "securities" for purposes of the federal laws, but we now so hold. Our question is whether the lawyers and the accountants can be secondarily liable to the class for the Co-op's failure to register its demand note issue.

In *Stokes v. Lokken,* 644 F.2d 779 (8th Cir. 1981), the court held that a lawyer who prepared an opinion letter suggesting that sales of silver coins on margin did not constitute a securities transaction was not liable to purchasers on federal registration claims. "In a suit for damages," the court said, "liability is imposed under § 12 of the Act, 15 U.S.C. § 77(1), on persons who offer or sell securities in violation of § 5. Thus, the conduct of the alleged aider and abetter must somehow bring him within the purview of § 12, which by its very language applies only to sellers." *Id.* at 785. Liability, the court held, is limited to those in privity with the buyers and those whose participation in the buy-sell transactions is a substantial factor in its taking place.

There is no evidence at all to suggest that any of the lawyers or accountants were in privity with any of the purchasers. It does not even appear, for purposes of the federal statute, that any of the lawyers or accountants

performed any act which was a substantial factor in causing any one sale to take place, in the sense of "seduc[ing] the prey and lead[ing] it to the trap. . . . " *Pharo v. Smith*, 621 F.2d 656, 666, *on reh'g*, 625 F.2d 1226 (5th Cir. 1980). The *Pharo* court, whose opinion was cited approvingly by *Stokes v. Lokken, supra*, determined that it was necessary to show that a non-seller, or one not otherwise in privity with the buyer, was an *inducing cause* of the sale. This record falls far short of such a showing.

The question is different under the state securities act. First, liability is not limited to persons who sell or control the seller, but rather extends to specifically enumerated parties including "employees" who materially assist the sale. Ark. Stat. Ann. § 67-1256(b) (1980 Repl.). There is no suggestion that material assistance is limited to behavior which induces a sale; indeed, an argument can be made that persons of sufficient authority in the enterprise who perform ministerial acts at another's direction may be held liable for the sale of non-registered securities. Furthermore, while the list of those statutorily liable under the law would appear to be exhaustive, the statute appears to indicate that such a roster is not meant to be exclusive. Ark. Stat. Ann. § 67-1256(h) says that the rights and remedies provided by the law are in addition to those otherwise provided by law or equity. We take this to mean, in the context of a remedial statute, that if the common law were to offer a plaintiff a remedy against a person as a joint tortfeasor, who would otherwise escape liability because not an officer, director or employee materially assisting the sale, then subsection (h) should be applied to give the buyer a right and remedy against that party.

In Arkansas, all who "actively participate in committing a tort, or who command, direct, advise, encourage, aid or abet its commission, are jointly and severally liable." *Lewis v. Mays*, 208 Ark. 382, 186 S.W.2d 178 (1945). It does not appear to us that any of these defendants commanded, directed, advised or encouraged the sale of unregistered demand notes. The sales had been going on for two decades before any of these gentlemen arrived on the scene. The most that can be said is that they failed to advise against the sales. Going farther out, the suggestion is made that defendants conspired to issue demand notes in order to keep the Co-op afloat.

It is now appropriate to deal with plaintiffs' remaining conspiracy theories. We have held that "an argument can be made" that Ball and Mourton conspired with White, Creekmore, and possibly others to transfer stock of White Flame Fuels to the Co-op, and thereby involved themselves in a common law conspiracy to defraud and a conspiracy to violate the securities acts. The argument can be made because (a) it is not subject to dispute for purposes of this motion that a meeting took place on November 25 during which a plan was devised to finalize the transfer of the plant to the Co-op; and (b) that after the meeting acts in furtherance of the plan were done by each individual said to be a party to the conspiracy. As a result, the Co-op was damaged. The only dispute concerns the *animus* of the various parties: innocent, negligent, reckless or fraudulent. In that connection, we found that jury questions were made out. If a party was merely negligent, of course he couldn't be a conspirator. But a jury is entitled on the evidence to find otherwise, and, if so, entitled to find that the transfer proceeded by design.

By way of contrast, there is no evidence that these defendants conspired to sell demand notes. Certainly they knew the notes were being sold. The Co-op was selling these notes for two decades and everyone knew it. That is to say, one can hardly say that it was Mr. Ball's idea to sell the notes. Nor is there any evidence that anyone even asked him his opinion whether they should be sold. Perhaps it was "negligent" for him not to fire off a letter demanding that all sales cease; however, we doubt that. He never agreed to act for the Co-op in that capacity. Maybe it was somehow advantageous for him to acquiesce in their sale. That is, however, not the same thing as conspiring to sell them.

What evidence is there that Ball and Mourton conspired to sell demand notes? There is none. Nor is there any evidence that Arthur Young conspired to sell the notes. A tendentious argument can be made that the Co-op had to attract financing any way it could, and that the professionals realized that Jack White's mismanagement would be discovered if access to capital were closed off. This does not prove a conspiracy "clearly and convincingly" or lead a reasonable juror to "belief" in its existence. The first thing Arthur Young did was make entries reflecting demand note funds as 100% current liabilities, which drove the current rates down well below 1.0. Is one to suppose that this was done to encourage more demand note activity? Or at the behest of Creekmore? Or pursuant to a plan with Ball and Mourton? Or at White's direction? Why then was White so displeased with Arthur Young's 1981 audit? (Ex. 400). Was this merely a clever ploy to throw skeptical directors off his trail? The court is satisfied that no reasonable juror could conclude that Arthur

Young conspired with anyone to sell unregistered demand notes. The plaintiffs bear the burden of proving this assertion clearly and convincingly, and they have not done so.

Anderson v. Liberty Lobby, 54 U.S.L.W. 4755 (1986), holds that a trial court must take into account the substantive burden of proof in passing on summary judgment questions. Specifically, it says that plaintiffs must offer "concrete" proof of matters such as conspiracy, *id.* at 4759, in the absence of which a judgment should be entered against the proponent. There is nothing concrete in this record suggesting that defendants conspired to market the notes, and so they will be awarded summary judgment on that question.

Absent a conspiracy, we believe that there can be no finding of liability on the state and federal non-registration claims. The court does not believe that any of the defendants "induced" the sale of an unregistered demand note. Such a finding is apparently a prerequisite to holding a person liable under the federal statute. We do not believe that it is necessary to show inducement under the state act. However, since the lawyers and accountants are not parties primarily responsible for seeing to it that the demand notes are registered in the first place, a finding of liability under Ark. Stat. Ann. § 67-1256(a) (1) would require a greater showing of responsibility for the *illegal nature* of the sale than is shown here. Any more dilute holding would automatically require all lawyers and accountants peripherally aware of any financial activity involving a client to make uncompensated inquiries (since they were not part of the engagement) into the often complex world of securities law at the risk of being

found responsible for millions of dollars worth of rescinded transactions by plaintiffs looking for a "deep pocket." Of course, if there were evidence to show that such parties induced sales of unregistered securities, or wrongly advised primary parties not to register their offering, or "controlled" the seller, then the law might very well hold such a party responsible, either directly, or by way of contribution on a crossclaim. We say only here that at no time did Arthur Young or Ball and Mourton solicit, advise, or encourage the sale of unregistered securities, and at no time were they under any duties to run an independent assay of their clients' financial practices to assure compliance with the state and federal laws. As another court said in another context:

> To accept the SEC's position [that auditors must perform closer examinations of a related company's account balances and assets, through which all the funds for the primary entity's programs were channeled] would go far toward making the accountant both an insurer of his client's honesty and an enforcement arm of the SEC. We can understand why the SEC wishes to so conscript accountants. Its frequently late arrival on the scene of fraud and violations of securities laws almost always suggests that had it been there earlier with the accountant it would have caught the scent of wrongdoing and, after an unrelenting hunt, bagged the game. What it cannot do, the thought goes, the accountant can and should. The difficulty with this is that Congress has not enacted the conscription bill that the SEC seeks to have us fashion and fix as an interpretive gloss on the securities laws.

S.E.C. v. Arthur Young & Co., 590 F.2d 785 (9th Cir. 1979).

To hold Arkansas accountants liable under the blue sky laws simply for failing to "pick up on" a client's failure to register his securities would conscript them for the advantage of the plaintiff's bar. Absent conspiracy, we find no warrant for that. We do not find that a reasonable juror can conclude that the accountants or the lawyers knew that the corporation was selling unregistered securities; consequently, such secondary parties not being otherwise under a duty, like the directors, to find that out, we hold that they cannot be shown to be responsible for sales of unregistered securities.

B. FRAUDULENT SALES OF DEMAND NOTE SECURITIES UNDER RULE 10b-5 AND THE ARKANSAS BLUE SKY LAW

The court has had extreme difficulty parsing the class's 10b-5 complaint. We note, for example, that the 10b-5 violations are alleged to have commenced, with respect to the class, in "February 1980." (Consolidated Complaint ¶119). We gather from that allegation that plaintiffs have chosen the earliest possible date on which the gasohol plant might fraudulently have been transferred to the Co-op. If the Co-op "owned" the plant earlier than that time, the inference of fraud in the underlying transfer diminishes. The inference of later fraud becomes also less plausible. If the Co-op was an "owner" of the plant as far back as May, 1979, the inference of fraud in the underlying transfer diminishes almost entirely. It takes on, rather, the cast of a very bad deal, a foolish investment, the kind of misfortune which has so often attended parties investing in "alternative energy sources" over the past dozen years or so.

However, it cannot be the transfer of the plant, *simpliciter*, which constitutes a 10b-5 violation with respect to the class. As we explained earlier, that alleged fraud harmed the Co-op unitarily, and not its investors distributively. *See Robertson v. White*, 633 F. Supp. 854, 865 (W.D. Ark. 1986). Rather, sales of demand notes occurring *after* the transfer are the only ones infected by the bacillus of 10b-5, and then only because the Co-op, through its newsletter and other media, made statements to the public which were misleading (because incomplete) or untrue.

Our first difficulty, then, is with the "February, 1980" date. It is, in a word, imprecise. We do not have to solve the mystery of when during February the 10b-5 violations began (the first sale after the "decision" to buy the plant on February 15, 1980?) because we believe that the limitations period began later.

Briefly, the Co-op filed bankruptcy on February 23, 1984, and on February 15, 1985, Tom Robertson, the trustee, brought suit on behalf of the Co-op *and* demand noteholders, alleging 10b-5 violations, *inter alia*. Several defendants protested his standing as a class representative, *Caplin v. Marine Midland Grace Trust Co.*, 406 U.S. 416 (1972), and on May 8, 1985, the class of demand note buyers petitioned to intervene in Robertson's suit alleging class claims, including this 10b-5 action. We believe that only the class filing, and not the trustee's filing, tolls the limitation period.

First, the trustee is not now and has not ever been a member of the class. He represents, and always has, an entity hostile to the class, although he administers the

estate in their behalf. This is *not* a case such as *American Pipe and Construction Co. v. Utah,* 414 U.S. 538 (1974), or *United Airlines, Inc. v. McDonald,* 432 U.S. 385 (1977). In those cases parties who at least potentially had standing to file on behalf of a class were deemed to have tolled limitations periods for their brethren, even though the class was never certified because of numerosity questions. Fed. R. Civ. P. 23(a). Nor is this a case where the class allegations are stricken because the plaintiff, even though a member of the class, is deemed to be an inferior representative for their interests. Here, plainly and simply, on the face of the complaint, the trustee is legally disqualified from bringing an action on behalf of the class.

In this case we have no hesitance in holding that the trustee's filing did not toll the limitations period from running against the class. To permit such a filing to toll the period encourages an officiousness by interlopers we should be vigilant to check, and needlessly deprives defendants of a repose which the statute creating the right determines that they should enjoy. A *disqualification* of a class representative because of supposed *inadequacy* is premised on factual determinations which no one is presumed to know; whereas the trustee's disqualification in this case is a matter of legal standing, deducible from the complaint. Everyone is presumed to know that a trustee cannot represent creditors on their personal causes of action, as that is the law. One who acts in ignorance of the law does so at his own peril, a lesson which the trustee vividly imparted to the directors not four months ago. Thus if any class member had looked at the complaint, he would have been on notice that the

trustee's standing was questionable, and on notice to protect his own rights. But since the cases do not require or even presume reliance by passive class members, *American Pipe and Construction Co. v. Utah, supra,* at 551-553, our question becomes whether non-vigilant parties should be able to defeat a substantive right of repose given defendants because of the actions of a pure interloper. We do not believe that they should. Manifestly, in a case such as this, the court's interest in avoiding a multiplicity of actions and promoting litigational "efficiency," *American Pipe, id.* at 553, is not served by tolling the statute. Here it is the trustee's initial class suit which caused the "multiplicity." Until a proper potential class member filed, there was not even a case or controversy for us to decide with respect to the class.

Second, the trustee suggests that Carl Greul's November, 1984, securities filing in Oklahoma tolled the period for a year. This action was later voluntarily dismissed. We disagree for a number of reasons: (1) the Oklahoma filing did not name these defendants; (2) the Oklahoma complaint did not put them on notice in such a manner that, had it been amended, it would have "related back" against these defendants under Fed. R. Civ. P. 15; (3) the savings statute giving plaintiffs a year to refile the action after voluntary dismissal does not apply to statutory causes of action carrying their own special limitations periods. *See Sandusky v. First Elec. Co-op.,* 266 Ark. 588, 587 S.W.2d 37 (1979).

We decide, therefore, that the limitations period starts, at the earliest, on May 8, 1980, five years before the class filed its petition to intervene. [We borrow the limitations period in the Arkansas Securities Act, because it is

most cognate for purposes of 10b-5 questions. Also, implicitly, the Eighth Circuit recently approved borrowing limitations from a state blue sky statute in *Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir. 1986); *see also Vanderboom v. Sexton*, 460 F.2d 362, 363 (8th Cir. 1972) (borrowing Arkansas blue sky statute's limitations period for purposes of 10b-5).]

For sales of demand notes occurring after May 8, 1980, we are directed to the following series of questions: (1) whether there was a fraudulent manipulation by the Co-op or any of the defendants prior to the events of November 12, 1980 – December 19, 1980; (2) whether there was a 10b-5 manipulation occurring after November 12/December 19; and (3) the extent to which Creekmore can be liable for any sales occurring after December 31, 1980.

One thing must be kept clear: the *transfer* of the gasohol plant to the Co-op does not constitute a 10b-5 violation *vis a vis* the class. Since the Co-op received, or purchased, all of White Flame's shares, White and his confederates may be liable to the trustee under 10b-5; however, White and his confederates are not liable to the class. The court doubts that this demands much explanation, given the pains taken by the court to distinguish between corporate causes of action and shareholder causes of action in its earlier opinion. Our holding on this point, however, is not merely an application of that ruling. Rather, it proceeds from the nature of the 10b-5 cause of action itself.

10b-5 offers remedies to persons defrauded "in connection with" their decision to purchase or sell their

stock. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975). The problem is conceptually different, therefore, from a question whether a shareholder has a personal cause of action against a party who defrauded his company. *Blue Chip Stamps* denies 10b-5 relief to share*holders*, extending it only to parties who purchase or sell shares "in connection with" a fraud.

The class's 10b-5 claim properly concerns itself not with events leading up to the transfer of the gasohol plant to the Co-op, but with manipulations occurring afterwards to conceal the financial status of the depleted corporation. As the court is able to understand the factual issues, the "earlier on" the Co-op legitimately acquires the gasohol plant, the less materially misrepresentative are any of its statements and presentations to its membership and demand note buyers. Accountants assign different values to a fixed asset depending on whether the enterprise purchases it from another source, or constructs it on its own. If the Co-op "always owned" the gasohol plant, then its capitalization could vary significantly from a value attributable to the plant if it were purchased substantially complete and ready to produce from Jack White in February, 1980. Under the latter hypothesis, a significant part of the moneys expended by the Co-op after that date would have to be expensed.

Furthermore, if the Co-op "always owned" the gasohol plant, there would be no need, especially, for the Arthur Young accountants to procure an appraisal of the plant. But if the transaction by which the Co-op acquired the plant were a "business combination," then they may have been required still to carry the asset on the books at "cost," but with this difference: the asset would need to

be valued, and any excess of cost over market would have to be assigned as "good will." (Accounting Practices Board [APB] Opinion No. 16, ¶ 87). It is possible that Arthur Young would have had to have carried as much as $3.7 million of good will before the membership.

One can easily see the advantages to Jack White of an accounting/auditing procedure which postulated that the Co-op "always owned" the gasohol plant. What the court frankly has a good deal of difficulty understanding is Arthur Young's apparent inconsistency in treating the plant as having always been owned by the Co-op. When Harry Erwin of Arthur Young was asked about the gasohol plant by the Co-op membership during the 1982 meeting, he evaded questions about it saying that it was "a separate operation" (AY 011090) under "state law." The questions at this meeting, recorded in the minutes, appear decidedly hostile to the Co-op's management. Expenditures on legal fees and the gasohol plant were closely questioned. One can imagine just what questions would have been asked if the Co-op's members' equity were completely consumed by "good will." To most laymen in this area, "good will" means "the old folks going to the old store," a concept difficult sensibly to apply to a gasohol plant. A jury may conclude, in fact, that if Arthur Young had used an accounting treatment more in harmony with the facts, reorganization proceedings would have begun much earlier. Obviously, people buying notes after that date would not have been injured in their property. The question is whether Arthur Young's accounting treatment, which we have earlier held to be capable of being deemed at least reckless by a reasonable

jury, violates the anti-fraud provisions of state and federal law. Arthur Young argues that there can be no securities fraud liability extending to it because no one specifically relied on any of its representations concerning the financial status of the Co-op. As we mentioned, in dealing with Count IV of the complaint, this is a potent defense to any claims made under the common law. We are not convinced that this is the case under the securities laws.

I. THE ARKANSAS ANTIFRAUD SECURITIES LAWS

The Arkansas Securities Act provides:

Civil liability – (a) Any person who

(1) . . . . ,

(2) offers or sells a security *by means of any untrue statement* of material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they are made, not misleading (*the buyer not knowing of the untruth or omission*) . . . is liable to the person buying from him . . . . (emphasis added).

The court understands that the state law, by its very terms, makes "reliance" by the buyer irrelevant; instead, the seller may avoid liability by proving that the buyer knew the truth. The Uniform Securities Act, upon which this section of the Arkansas Act was almost identically modeled, does not require a showing of reliance. As the Commentary to the Uniform Act declares:

> The "by means of" clause in line 8 is not intended as a requirement that the buyer prove reliance on the untrue statement or omission. He must show only that he *did not know of it. See Murphy v. Cady,* 30 F. Supp. 466, 468 (D. Me. 1939), *aff'd sub nom., Cady v. Murphy,* 113 F.2d 988 (1st Cir. 1940), *cert. denied,* 311 U.S. 705, under § 12(2) of the Federal Statute.

Uniform Securities Act, Draftsmen's Commentary to § 410(a). The federal act, of course, has a limitations period of one year, instead of five, and the class did not commence its action until fifteen months after bankruptcy was declared. Thus, claims which are barred under § 12 of the Federal Securities Act of 1933, because of the passage of a year, can find a home within the Arkansas Blue Sky law, whose cognate provisions enjoy a five-year limitation period. Ark. Stat. Ann. § 67-1256(e).

The remaining question for decision is whether parties such as accountants and lawyers, who do not "control" a seller, are liable under the law. Ark. Stat. Ann. § 67-1256(b) states that "every person who controls a seller liable under subsection (a) . . . every partner, officer, director . . . every person occupying a similar status or performing [a] similar function, every employee of such seller . . . who materially aids in the sale . . . are *also* liable jointly and severally with . . . the seller . . . . " (emphasis added).

The statute gives defrauded parties not only rights against the "seller," *i.e.,* the Co-op, but also against individual directors and employees of the Co-op. It departs from the common law in this respect. Under the common law, one is not given a right of action against a corporate

director simply because the third party was tortiously injured by the corporation. *Washington Gas Light Co. v. Landsden,* 172 U.S. 534 (1899). Furthermore, a director or officer of a corporation is not liable, merely because of his official character, for the frauds or false representations of the other agents of the corporation, or for fraud attributable to the corporation itself, if such officer or director is not personally connected with the wrong and does not participate in it. *Teledyne Industries, Inc. v. Eon Corp.,* 401 F. Supp. 729 (S.D.N.Y. 1975), *aff'd,* 546 F.2d 495 (2d Cir. 1976). Of course, the rule is otherwise if the officer or director participates in the fraud – he is liable like any other joint tortfeasor.

The Arkansas Securities Act invades the common law to the extent that it enumerates parties who might not ordinarily share liability with the "seller," and imposes a statutory rescission liability against them. We do not believe that Ark. Stat. Ann. § 67-1256(b) is meant to supplant the common law, by exculpating those parties who otherwise would be liable as joint tortfeasors, or "aiders and abetters" if you will. Indeed, subsection (h) of the same statute says: "The rights and remedies provided by this act are in addition to any other rights that may exist at law or in equity."

The court believes that it would be contrary to the remedial purpose of the law to permit an active tortfeasor to escape liability in this situation. If the jury were to find that once Jack White left the Co-op in 1982, that the only persons who were aware that the Co-op was actually insolvent were the accountants and, that out of a misplaced loyalty, the accountants decided to distort the Co-op's true financial picture, knowing that people were

actively investing in the enterprise: does it "make sense" that the only parties who could be held responsible under the law were the directors, whose intent was non-fraudulent? The law would require them to prove that they did not know of the insolvency, which would mean that they would produce the audit report and claim a "good faith defense." The case against the directors would fall because they had no way of knowing (or suspecting) that accountants would perversely issue a deliberately distorted report. The accountants would claim that no common law action could be maintained against them because no one specifically relied on what they did say; although, conversely, no one would have bought a security if they knew the Co-op to be insolvent. Only if the directors failed to prove "good faith" would the accountants ever be called to court for their misdeed, because they would be liable *to the directors* in contribution. (Ark. Stat. Ann. § 67-1256(b)). The defrauded parties, under this restrictive view, could have no direct rights against the *only* parties responsible for the fraud. All of this obtains from a statute designed to "protect investors" by encouraging "full, truthful disclosure."

The court believes that the Arkansas Securities Act contemplates, through subsection (h), that parties who at common law would be jointly and severally liable with the "seller" for the sale of securities "by means of any untrue statement," should be liable under the blue sky law as well. These would include the Arthur Young accountants who breached a duty owed to the class. Under the Restatement (Second) of Torts § 876(c), a party is subject to liability to another harmed by the acts of a third party if he "gives substantial assistance to the [third

party] in accomplishing a tortious result and his own conduct, separately considered, constitutes a breach of duty to the third person." We have already discussed, *supra*, with respect to Count IV of the complaint, how the Arthur Young accountants owed a duty to the members of the class not to intentionally misstate the Co-op's financial status. The common law recognizes that duty, but holds that one may not be liable where the "victim" did not rely on the statement, or even if he did not "reasonably rely" on it. "Reliance" under the common law is a measure not of the defendant's duty, but of causation for the plaintiff's loss. Under the Restatement's test, an accountant can be held jointly liable with a seller for fraudulently misrepresenting financial information in a securities transaction.

Alternatively, the accountants can be said to exercise sufficient "control" over the seller, with respect only to the dissemination of misrepresentative material, to justify the imposition of liability under § 1256(b). "Control" is not defined by the statute. However, in *Hawkins v. Merrill Lynch*, 85 F. Supp. 104, 123 (W.D. Ark. 1949), the court noted that in the context of the federal statutes, "control" did not mean "that degree of control or the right to direct necessary to make out a common law relationship of principal-agent or employer-employee." The court believed that a more flexible meaning was intended by Congress.

We believe that the same can be said for the Arkansas blue sky law. If a third party has the power to influence the way that financial information is disseminated to the public, he exercises some measure of control over the seller and the transaction. The record shows that Arthur

Young reviewed the condensed financial statements, and perhaps in a sense approved them. The evidence tends to show that they were given proofs of the 1982 statements with notations saying that the materials were prepared from an audit report conducted by Arthur Young & Co. It would appear that at that point, certainly, Arthur Young & Co. had the "power" to protest the way in which its name was used to project materially misleading information. The court hesitates to say that this power automatically amounts to control of an issuer for all purposes; however, for the limited purpose of determining Arthur Young's ability to influence the course of dealing by the Co-op, it is not insignificant that the Co-op passed the materials on to Arthur Young "for approval" and Arthur Young chose not to exercise its prerogatives, though it certainly could have, and would have been more than justified in protesting the use of its name in that context.

We believe, therefore, that Arthur Young's motion for summary judgment on the *state* anti-fraud statutes should be denied. Plaintiffs do not have to prove reliance, and, we believe, are capable of bringing actions against responsible parties not specifically named in the statute.

We do not believe, however, that any evidence has been adduced showing Ball and Mourton to be responsible for any state securities law violations, or showing Carl Creekmore to be responsible after December 31, 1980, when he retired and ceased being, even arguably, a "controlling person." The court will grant Ball and Mourton summary judgment on these claims, and Carl Creekmore a partial summary judgment. If it appears that no demand notes were sold "by means of" an untrue statement of material fact before December 31, 1980, Carl

Creekmore can move for a verdict on the evidence with respect to those issues as well.

~~Def~~endants have also filed motions for summary judgment against the class's 10b-5 claims. We are in greater sympathy with defendants' motions under the federal laws than we are under the blue sky law. Rule 10b-5 at least arguably requires a showing of reliance missing from plaintiffs' proofs. We note, however, that the element of reliance – not mandated by the rule – has been eroded partly by the Supreme Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972), and partly by the Eighth Circuit in *Barnes v. Resource Royalties, Inc.*, No. 85-1715, CCH ¶ 92,808 (8th Cir. 1986). We believe it therefore best at this time to deny Arthur Young's motions for summary judgment under Rule 10b-5. First, the same evidence and basically the same theories will be ventilated in both the state and federal law securities claims. To the extent that there is any departure, it is in the area of damages, and we have not yet decided whether damages will be heard by the jury or by the court. (This matter was left unresolved by our October 9, 1986, pretrial.) Second, the court believes that it will be far more strategically placed to reconsider this motion at trial, when the question will be presented on a more complete record. The court confesses having some difficulty reconciling *Vervaecke v. Chiles Helder*, 578 F.2d 713 (8th Cir. 1978), with some of the more recent pronouncements from our court of appeals. It "makes sense" to the court that every misrepresentation contains within itself the seeds of an omission; and that, therefore, unless it is watched, the *Affiliated Ute* presumption will swallow all reliance requirements under Rule 10b-5. The court frankly

views cases like *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723 (1975), as sounding an end to the expansionist notions of the securities laws expressed in *Affiliated Ute Citizens v. United States, supra*, and *Superintendent of Insurance v. Banker's Life & Casualty Co.*, 404 U.S. 6 (1971), both older cases. This concern is especially pronounced because of *Blue Chip Stamp's* reference to the appropriateness of adverting "to the tort of misrepresentation and deceit, to which a claim under Rule 10b-5 certainly has some relationship." *Ibid.* at 744. We understand the discussion following that reference to relate that transactions on an impersonal market may justify a departure from rules of earlier days. We wonder, then, in this connection, why the cases promoting a relaxation in the rule have occurred in face-to-face transactions: *Affiliated Ute* involved discrete contacts between the "market making" bankers and the Indians; *Barnes v. Resource Royalties, supra*, involved non-market transactions between a buyer and a seller. Only *Union Electric Co. v. Harris*, 787 F.2d 355 (8th Cir. 1986), concerns an omission misleading the market. Defendants question its applicability to our case because there was no "market" for Co-op demand notes: the "loss causation" in *Harris v. Union Electric, supra*, was a result of the misrepresentation and the effect of its disclosure on "the market." Here, the underlying business problems caused the loss, not the alleged misrepresentation. Arguably, the misrepresentations in this case were neither "transaction causative," or, strictly speaking, "loss causative." Rather, they merely "failed to deter" transactions. The court has a great many questions whether a representation which failed to induce a transaction should be civilly redressed under 10b-5 because it failed to deter one.

With respect to Ball and Mourton, and Carl Creekmore, the court finds no.evidence that they conspired to market the demand notes, or otherwise are liable for the violations of Rule 10b-5. Creekmore, again, will be given only a partial summary judgment, for any transactions occurring after December 31, 1980. If the facts show that no material omissions tainted sales made before that time, or if otherwise appropriate, we will entertain a later motion from him on the federal securities laws claims.

VII. COUNT XII: RICO ACTIONS AGAINST THE LAWYERS AND ACCOUNTANTS

Defendants' legal objections to plaintiffs' RICO causes of action are twofold: first, that plaintiffs cannot prove that the lawyers and accountants participated in the management or control of the Co-op, *Bennett v. Berg*, 710 F.2d 1361, 364 (8th Cir. 1983) (en banc); second, that plaintiffs cannot prove that the lawyers and accountants managed any enterprise "through a pattern" of racketeering activity. *Holmberg v. Morrissette*, No. 85-5138 (8th Cir., *slip op*. Sept. 3, 1986); *Superior Oil Co. v. Fulmer*, 785 F.2d 252 (8th Cir. 1986).

To the extent that plaintiffs base their case against Arthur Young and Co. on allegations that it participated in the operation or management of the Farmers' Co-op, they must fail. Plaintiffs have compiled an extensive record; yet, from it they are able to show just five acts by Arthur Young which they suggest support a finding of control: (a) the accountants allegedly created the Co-op's financial statements; (b) the accountants failed to obtain

client representation letters; (c) they addressed shareholder meetings; (d) they participated in the creation of condensed financial statements; and (e) the accountants helped the Co-op handle certain matters with government agencies. Perhaps the court misunderstands plaintiffs' theories in this regard, but these activities hardly bespeak the kind of "operation and management" with which we understand *Bennett v. Berg, Ibid.*, to be concerned. Plaintiffs have failed to show anything more than that the acountants reviewed a series of completed transactions, and certified the Co-op's records as fairly portraying its financial status as of a date three or four months preceeding the meetings of the directors and the shareholders at which they presented their reports. We do not hesitate to declare that such activities fail to satisfy the degree of management required by *Bennett v. Berg, Id.*

Conceding that the question of "control" is closer with respect to the lawyers Ball and Mourton, and Carl Creekmore, we nevertheless find that a RICO case has not been made out against them because plaintiffs have failed to prove that they conducted the affairs of the Co-op through a pattern of racketeering activity. In *Sedima v. Imrex*, 105 S.Ct. 3275 (1985) the Supreme Court observed in passing that the lower federal courts had failed to develop a meaningful definition of "pattern" in RICO cases, a failing, we submit, for which Congress is primarily liable, having authored the legislation without defining a critical term. That the *Sedima* court would footnote this issue, one which was not raised by the questions raised in the *certiorari* petition, nor certified by the court for review, is an indication that the court was troubled by the indiscriminate use of RICO by plaintiffs victimized by otherwise unremarkable frauds.

We are persuaded by two recent Eighth Circuit opinions that plaintiffs have failed to prove that the lawyers participated in the conduct of the Co-op through a pattern of racketeering activity. The earlier opinion of the two held that a single long-running scheme victimizing a single entity does not constitute a RICO pattern. *Superior Oil Co. v. Fulmer, supra*. The latter opinion held that multiple parties separately victimized by activities relating to a single transaction are confined to their common law remedies since a showing of activity connected with a single transaction negates a finding of a "pattern" of racketeering activity. *Holmberg v. Morrissette, supra*.

In *Superior Oil Co. v. Fulmer, supra.*, three individuals siphoned natural gas from a pipeline for refining and resale, covering up their misdeeds by posting a number of fraudulent meter readings through the mail. There was no evidence that the three committed other acts of the same tenor, or that they had ever attempted to do so. The court of appeals reversed a jury verdict finding the three liable for damages under RICO saying:

> " . . . [P]roof of a 'pattern of racketeering activity' 'requires more than one "racketeering activity" and the threat of continuing activity to be successful. It is this factor of *continuity* plus relationship which combines to produce a pattern.' . . . Superior Oil clearly has proved the 'relationship' prong. They proved several related acts of mail and wire fraud in pursuit of the underlying conversion or theft of gas from Superior Oil's interstate pipeline. . . .
>
> Superior Oil has, however, failed to prove the 'continuity' sufficient to form 'a pattern of racketeering activity'. The actions of Fulmer,

> Branch and Nichols comprised one continuing scheme to convert gas from Superior Oil's pipeline. There was no proof that Fulmer, Branch or Nichols had ever done these activities in the past and there is no proof that they were engaged in criminal activities elsewhere.
>
> Superior Oil attempted to show that Fulmer, Branch and Nichols intended to engage in similar gas conversion schemes at other locations. Although it may be that proof of a threat of continuing racketeering activities in the future could, in combination with ongoing acts of racketeering, be sufficient to establish a 'pattern of racketeering,' we find insufficient proof of such a threat here."

The *Fulmer* court, in short, agreed with *Northern Trust Bank/-O'Hare N.A. v. Inryco, Inc.*, 615 F.Supp. 828, 832 (N.D.Ill. 1985) which said that "[i]t is difficult to see how the threat of continuing activity stressed in the Senate Report could be established by a single criminal episode," noting that "[i]t places a real strain on the language to speak of a single fraudulent effort, involving several fraudulent acts, as a 'pattern of racketeering activity'."

We view *Superior Oil* as imposing a "single scheme" limitation on civil RICO cases. Where repetitive criminal activity expresses itself in a single fraudulent effort, the victim will be left to his common law fraud remedies, just as he was in pre-RICO days. We read *Superior Oil* to hold that the federal interest is ignited only when a party mounts repetitive efforts in distinct episodes.

Whatever doubts we may have entertained about *Superior Oil's* single scheme limitation were removed by the Eighth Circuit's more recent decision in *Holmberg v.*

Morrissette, supra. The court of appeals decided that the trial court erred in holding the defendant liable under RICO where the plaintiff (one of three parties each of whom was separately defrauded by the defendant,) was held to have been victimized only in connection with a single scheme, and not otherwise in connection with a pattern of racketeering activity. In *Holmberg,* three letters of credit, issued by the victims, separately secured the defendant's interest in a business transaction involving an exporter. To avoid a loss, defendant forged invoices and bills of lading to draw down the letters of credit. Even though the *Holmberg* facts (three separate acts, three different victims) differed from *Fulmer's* (one continuous siphoning, one victim), the Eighth Circuit declined to characterize this departure as material for purposes of civil RICO. The court said:

> "This court thoroughly discussed the parameters of 'pattern' in *Superior Oil Co. v. Fulmer* . . . In *Superior Oil,* we held that several related acts of mail and wire fraud as a part of a single scheme to divert natural gas . . . did not amount to a racketeering activity. There was no evidence suggesting that such activities had occurred previously or that the individuals involved were engaged in other criminal activities. . . . We believe the present case is legally indistinguishable from Superior Oil . . .
>
> . . . .
>
> We assume for purposes of our review that Holmberg proved that defendants committed acts of wire or mail fraud related to a common purpose or scheme. Our review of the record convinces us, however, that Holmberg has failed, as a matter of law, to prove the continuity

> necessary to form a 'pattern' of racketeering activity. Defendants' actions comprised one scheme to draw down the three letters of credit securing Mintex's transactions with TransWorld with respect to goods specially produced by Mintex. . . . In one sense defendants' actions were a misguided attempt to obtain payment for goods which they had produced, yet over which they had no control."

In this case, the evidence suggests that the lawyers combined to unload the gasohol plant on the Co-op. There is but one scheme. The plaintiffs' expressed theory of the case, as manifested in the Consolidated Complaint, charged all the defendants with "a [single] scheme to allow the Co-op to continue in existence, notwithstanding the depletion of its assets by looting". (Complaint ¶158). Somewhat tardily, plaintiffs suggest now that RICO case can be made against the lawyers because they twice victimized the Co-op: once to secure payment of White's legal fees, and once to transfer White's gasohol plant out of his hands.

One need only examine plaintiffs' introduction to its response to Ball and Mourton's motions for summary judgment to find expressed by plaintiffs their own view that the allegedly wrongful acts of the lawyers swung on a single pivot: the December 11, 1980, meeting of the Co-op Board. There Creekmore secured the authority to file both the declaratory judgment action, as well as a resolution authorizing the Co-op to pay the legal fees of White and Kuykendall. From that one meeting emerged a single victim (the Co-op) allegedly bilked by a single fraudulent device (fiduciaries serving masters with conflicting interests) for the direct benefit of one party (White). Collateral

benefits flowed to others, of course, but that fact is unimportant to this analysis.

The allegedly fraudulent activities in this case took place at one time and involved the same people. We do not believe that the Congress's concern that only continuing, repetitively manifested activities be redressed by RICO will be served if we indulge pleading fictions that balkanize essentially unitary transactions. The Eighth Circuit has twice clearly spoken against creative analyses of transactions that "plead defendants into RICO." A common sense view of the record seems to be clearly called-for. Where a single scheme appears, plaintiffs should be left to their common law remedies, unless the plaintiffs can show that the defendants "did it before and would do it again." In such an event, RICO manifestly has its place, and needs no artful pleading to secure it.

Even if the law allowed plaintiffs to make two schemes out of a single meeting of the Board, we believe that the payment of legal fees by the Co-op is not such a cause of action as necessarily sounds in fraud. Our view of the trustee's suit in Count I is that the gravamen of the action is one for money paid by mistake, sounding in restitution. Indeed, the cases upon which we relied in sustaining the trustee's claim acknowledged that recovery could be obtained without a showing of *scienter.* Among the theories suggested by the authorities as substantiating a claim in cases such as this one is "conversion" which, as Prosser notes, "defies definition," having its genesis in the law of trover, requiring only that plaintiff prove his right to possession and the defendant's exercise of dominion over the chattel. Prosser and Keeton, *Torts*, 5th Ed. 1984, pp. 88-90. We may at leisure

criticize the expansion of "conversion" to reach the receipt of money; however, in so doing, we note a recognition by those courts that such a claim is one which, like conversion, does not require a pronounced mental element.

We therefore believe that a pattern of corrupt management of the Co-op has not been proved. We would emphasize that "management" by the lawyers has been assumed rather than found. We do not wish to intimate that attorneys are especially prone to be found to control RICO enterprises simply by virtue of their calling. We suggest only that the question of "control" in this case is harder to reach than the question of pattern. Our findings, however, do not end our RICO inquiries, since plaintiffs have also charged that the lawyers and accountants operated their own firms as RICO enterprises, through a pattern of racketeering activity.[5]

Defendants E. J. Ball and Ken Mourton obviously participated in the management of the enterprise "Ball and Mourton." The individual Arthur Young accountants obviously participated in the management of Arthur Young. There is no proof in this record that either of these enterprises has been conducted through a pattern of racketeering activity. Rather, what we find is that to the extent that any of these lawyers' or accountants' dealings with the Co-op are wrongful, such dealings are aberrant, and in no way "typical" of the practice of these professionals.

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5 [Creekmore was not charged with having operated his own practice in that manner; consequently the RICO cause of action as to him is dismissed with no additional comment.]

We have mentioned our belief that the *Superior Oil* case imposed a scheme limitation on RICO. To the extent that an "outsider" directs or influences the affairs of an enterprise, we believe that RICO plaintiffs are obliged to show that he did so through a pattern of abuses. Such a pattern, we believe, cannot be found in events having a nexus to a single transaction. Such a limited showing simply does not permit a reasonable juror to conclude that the "outsider" intends to pervert the enterprise into an ongoing, continuing engine of fraud.

If the person charged under RICO is an "insider" in his own "enterprise," it is even less likely, as the *Sedima* court suggested, that two acts or schemes will suffice to prove a pattern. A person acting through the enterprise of another obviously has fewer opportunities to influence its behaviour than he does when acting through his own. This is obviously true in the cases of large law firms and accountancy firms, which will have the opportunity to "manage", loosely speaking, the affairs of hundreds and thousands of clients at a time. In a large and varied practice, a person who twice corrupts a single "outside" enterprise will more likely be found to have managed that particular enterprise through a pattern of wrongful activity, than he would his own. His "management" of the foreign enterprise may only consist of a limited number of transactions, and his readiness to exploit his association can be measured, quantitatively and qualitatively, against a much smaller range of activity. In such a case, two schemes may suffice.

When managing his own enterprise, wherein thousands of people are concerned, and many times that many transactions are implicated, it is correspondingly

harder reasonably to find a pattern of corruption arising out of only two discrete and widely separated acts. For example, if a professional service corporation were to send a single inflated bill to a client in 1973, and another to another client in 1982, it could hardly be said that it conducted its affairs through a *pattern* of racketeering activity. *Sedima v. Imrex, supra,* acknowledged the unreasonableness of finding a pattern in such activity, without holding that a pattern can never be found from a showing of two acts or schemes. The court believes that it is possible to find that an individual managed an entity through a pattern of racketeering activity if his "management" were found to consist of a sufficiently limited number of discrete acts, two of which were distinctively and separately fraudulent. Obviously, however, where one acts through his own enterprise literally thousands of times a year, it beggars sense to require him to stand trial under RICO for two overbillings occurring nine years apart.

We believe that RICO claims are most likely to be predicated on "two schemes" when a court is convinced that the schemes are *qualitatively* and quantitatively significant enough so as to permit a reasonable jury to conclude that they are somehow "characteristic" of the way a person conducts the affairs of an enterprise. If a person uses his business twice as an engine of fraud against the public in large scale securities offerings, the very distinctiveness of that behaviour may reasonably permit one to conclude that the defendant is determined to use his business as "a racket." By imposing a single scheme limitation on RICO, the courts are only forcing the statute to live up to its name. After all, any kind of

fraudulent activity above the level of Three Card Monte will involve more than two acts of mail or wire fraud. An interpretation of RICO which permits every such scheme trebly to be redressed essentially invites every fraud case to be filed in federal court. This would especially be so if, as plaintiffs suggest, RICO frauds need be proved only by a preponderance of the evidence, whereas common law frauds must be proved clearly and convincingly.

The record is devoid of proof that Ball and Mourton ever operated the affairs of Ball and Mourton so as to defraud any other party, and likewise that any of the individual accountants ever operated Arthur Young so as to defraud another. We therefore conclude that summary judgment must be entered on behalf of Ball, Mourton, Erwin, Cabannis, Drozal and Harrison. They neither controlled or managed the Co-op through a pattern of racketeering activity, nor their own firms. For these reasons as well, we dismiss Arthur Young's RICO crossclaims against the directors. Such claims, if they exist, clearly related to a single transaction or purpose, allegedly to keep the Co-op afloat.

VIII. CONCLUDING MATTERS

The remainder of the motions address allegations which have been thoroughly ventilated. For example, Ball and Mourton pray for summary judgment on Count VII which charges that they should return fees paid by the Co-op because they represented dual interests. We have already said that such an issue can be submitted to the jury as an element of other causes of action; the same is true when the trustee seeks a return of fees. It would

appear that Ball and Mourton stopped representing White in March, 1982. The court does not know whether the lawyers should be required to return fees for periods in which there was no conflict. In any event, that is an argument over "how much" not over "whether" and therefore not appropriate, we think, for summary judgment.

Similar dispositions will obtain for limitations issues, the existence of negligence questions, *etc., etc.* One must also bear in mind that damage issues, including punitive damages against these remaining defendants, have not been discussed fully, largely because they haven't been raised fully. Our decision that Ball and Mourton and Carl Creekmore performed no "acts" inimical to the Co-op after January, 1981, for example, does not foreclose the plaintiffs from proving that the Co-op suffered damages later which were proximately caused by them. We simply fail to find that these parties breached any duties owing to the various plaintiffs.

The case, we believe, is now ready for trial. Basically, the jury will be studying the events of May, 1979, to December, 1980, and in that connection will be focusing on the lawyers. A later focus will center on the events of August, 1981, to February, 1984, involving the accountants, especially with reference to damages suffered by audits presented in the spring of 1982 and 1983. Plaintiffs have not proven a conspiracy that would unite these events. One of the attractions of such theories is that they always "explain a lot." They are easy to hypothesize, harder to prove. This record offers no proof of an agreement, without which it would be plainly unjust to permit such an allegation to go to trial. We have had the occasion

to study the plaintiffs' claims that certain of these defendants are alleged to have "made up" a state of facts that allowed them to reach a result they desired. On the record presented by this case, the court would be guilty of that which the plaintiffs attack if we were to allow the jury to "make up" a scenario having no basis in the evidence simply to reach a result agreeable to the plaintiffs. We have therefore steered a course set by the polestar of *Anderson v. Liberty Lobby, Inc.*, 54 U.S.L.W. 4775 (1986), and have dismissed those claims because they utterly lack "concrete" support, and could never persuade a reasonable jury, clearly and convincingly, that such a state of facts exists.

An order will be issued contemporaneously herewith embodying these conclusions.

This 15th day of October, 1986.

/s/ H. Franklin Waters
United States District Judge

APPENDIX D

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as
Trustee of the Farmer's Co-Op
of Arkansas & Oklahoma, Inc.;
BOB REVES; FRANCES GRAHAM;
ROBERT H. GIBBS, individually;
ROBERT H. GIBBS, as natural
guardian of his minor children,
THOMAS A. GIBBS, and ROBERT H. GIBBS, JR.;
and ROBERT H. GIBBS,
as Trustee of the Muskogee
Internal Medicine Group Profit
Sharing Funds PLAINTIFFS

v. Consolidated Cases No. 85-2044,
85-2096
85-2155
85-2259

JACK E. WHITE, ET AL. DEFENDANTS

ORDER

Now on this 16th day of October, 1986, comes on to be heard defendants' motions for summary judgment. The court, on reviewing the pleadings, affidavits, depositions, exhibits, and other matters, finds:

1. That the motions of Arthur Young, and Ball and Mourton, for summary judgment on Count I are denied;

2. That the motions of Carl Creekmore, and Ball and Mourton, for summary judgment on Count II are denied, with the exception that Carl Creekmore's

plea of a bar by limitations is granted with respect to the Trustee's action for negligence;

3. That the motions of Carl Creekmore, and Ball and Mourton, for summary judgment on Count III are denied;

4. That Carl Creekmore's and Ball and Mourton's motions for summary judgment on Count IV are granted; also, that Arthur Young's motions for summary judgment on claims brought by the class in Count IV are granted; however, Arthur Young's motions against the Trustee's claims for fraud and negligence are denied;

5. Carl Creekmore's and Ball and Mourton's motions for summary judgment on Count VI are granted; Arthur Young's motions for summary judgment on Count VI are denied;

6. The motions of all defendants on Count XIII (R.I.C.O.) are granted;

7. The motions of Ball and Mourton on Counts VII and XI are denied; the motion of Carl Creekmore on Count XI is granted; the motion of Carl Creekmore on Count VII is denied;

8. The motions of separate defendant Stephen Adams are granted pursuant to Ark. Stat. Ann. § 65-117 (1980 Repl.).

IT IS SO ORDERED.

/s/ H. Franklin Waters
United States District Judge

APPENDIX E

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as
Trustee of the Farmer's Co-Op
of Arkansas & Oklahoma, Inc.;
BOB REVES; FRANCES GRAHAM;
ROBERT H. GIBBS, individually;
ROBERT H. GIBBS, as natural
guardian of his minor children,
THOMAS A. GIBBS, and ROBERT H. GIBBS, JR.;
and ROBERT H. GIBBS,
as Trustee of the Muskogee
Internal Medicine Group Profit
Sharing Funds — PLAINTIFFS

v. — Consolidated Cases No. 85-2044, 85-2096, 85-2155, 85-2259

JACK E. WHITE, ET AL. — DEFENDANTS

MEMORANDUM OPINION

A. Introduction

Shortly after the jury returned its verdict in this case, the court requested that the parties make all motions for judgment notwithstanding the verdict, new trial, for credit from settlements, etc., at one time so that a definitive judgment might be entered. Although the Rules of Civil Procedure indicate that certain motions are timely only after judgment is filed, we believe that it was the wiser practice in this case to call for all motions at once,

so that appeals and distributions to the class could commence as speedily as possible. Yielding to the request of the plaintiffs, we have today entered the judgment pursuant to Rule 54(b) of the Federal Rules of Civil Procedure, so that an appeal might be immediately taken by the parties, instead of having to wait for the final disposition of the settlement approval process, the parties and claims with respect to which were severed by the court before trial. Our intent has been to apply the Rules of Civil Procedure so as to effect the "just, speedy, and inexpensive" determination of this dispute, conformably with Fed. R. Civ. P. Rule 1. Nothing we have done in this context has been intended to eventuate in any prejudice to any of the parties, and we do not think that any has occurred by happenstance. Arthur Young & Co., and Ball and Mourton, the two defendants to stand trial, have basically re-raised arguments made during the course of the pretrial proceedings in motions to dismiss and for summary judgment. Rather than recite anew the complex facts adduced in the testimony, we would refer the reader to our discussions in our opinions covering the motions to dismiss and the motions for summary judgment, which we believe represent fairly complete recitals of the evidence (certainly there were few, if any, "surprises" at trial, the witnesses having been thoroughly deposed in marathon sessions extending from January through August, 1986). Accordingly, we will now pass on the issues raised by the parties (plaintiffs filed a motion for a new trial on one of the trustee's claims against Ball and Mourton, which will be discussed in passing in the immediately following section, in which the motions of Ball and Mourton are considered.)

B. The Motions of Ball and Mourton

Defendants Ball and Mourton have asked the court for a new trial, or for a judgment notwithstanding the verdict, arguing that their motion for a directed verdict should have been granted because there was no evidence in the record that any securities of White Flame Fuels, Inc., had ever been transferred to the Co-op as a result of the declaratory judgment action. Even though we note that defendants raised no objection to the evidence on that precise ground, we are prepared to assume for purposes of discussion that such an objection was made, and we hold as a matter of law that even in the absence of a showing that *stock certificates* passed to the Co-op, a transaction subject to the securities laws was fully shown by the evidence.

First, the relevant statutes do not require proof of a sale completed in all particulars, including proof of an "execut[ion of] the stock power on the certificates at issue here." (Defendants' Brief at 8). If that were so, one could easily swindle another in a sale of stock, and avoid the securities laws simply by breaching one's contract to execute the transfer. The statutes define "sale" to *include* "every *contract of sale,* contract *to sell,* or *disposition of* a security . . . for value." 15 U.S.C. § 77(a); Ark. Stat. Ann. § 67-1247(j) (1). (emphases added). One violates the securities laws by making a fraudulent *contract to sell* a security, even if the security is withheld or otherwise not officially transferred.

The White Flame transaction obviously falls within the statutory prohibition. The term "sale" in the securities laws is not limited to technical common law sales or

transactions ordinarily governed by the commercial law of sales. *People's Bank of LaGrange v. North Carolina Nat. Bank,* 139 Ga. App. 405, 228 N.E.2d 334 (1976). Accordingly, a written commitment by a broker to deliver shares of stock was held to be a "sale" in *Lawrence v. Securities and Exchange Commission,* 398 F.2d 276, 280 (1st Cir. 1968). We believe that a chancery court decree ordering White to transfer the shares of White Flame to the Co-op satisfies the statutory requirement of a "disposition of a security for value," and find defendants' arguments to be without merit.

Ball and Mourton have also re-raised the so-called "sale of the business" defense, which we previously ruled was fully discredited by *Landreth v. Landreth Timber Co.,* 105 S. Ct. 2297 (1985). If that defense survives at all, [a matter made only slightly doubtful by ambiguous *dicta* in a footnote in a trailing case, *Gould v. Ruefenacht,* 105 S. Ct. 2308, 2311 n.2 (1985),] it would not avail defendants in this case. Here, as in *Landreth,* the seller (White) retained managerial control of White Flame Fuels after the transaction, *see SEC v. W.J. Howey Co.,* 328 U.S. 293 (1946).

More troubling, by far, than the question whether the declaratory judgment action involved a sale or other disposition of a security is whether the securities laws were meant to reach the actions of non-sellers, who come on to the scene of an arguably "done deal," and suggest a method which gives the buyer $800,000 in values (tax credits useable for 15 years) *more* than what he would have attained if he took title solely to the property or assets of the corporation rather than to its shares. The irony is, of course, that if Ball and Mourton had done nothing more than suggest that the Co-op take title to the

plant and equipment of White Flame Fuels (the economic reality of the transaction, anyway,) no securities problem would be present, and the jury's finding under Count II would have completely exculpated the defendants. The seller (White) got not one penny's worth of value *more* by parting with his securities than he would have had he parted with the plant and equipment. The buyer, the "victim" in this scenario, acquired tax credits worth nearly $800,000, as plaintiffs' expert Grabosky conceded, which it would *not* have gotten if only the plant and equipment had been transferred to it. We very reluctantly conclude that because our task is to enforce the laws as they are written, we must sustain the jury's finding because there is substantial evidence from which they could have determined that defendants substantially assisted the transaction, in bad faith or recklessly, by a preponderance of the evidence.

The defendants assert that the sale of White Flame Fuels was a "done deal" prior to Ball's initial consultation about the matter on November 25, 1980. William Moon testified that on November 11, 1980, he spoke with White at the Co-op concerning the gasohol plant. White was anxious to find a wealthy buyer or group of investors to buy it for the "tax advantages." Moon's testimony indicated that White was knowledgeable about the tax considerations involved. Certainly, this was substantial evidence that the transfer had not in fact taken place.

While it is true, as defendants argue, that the Co-op directors testified, by and large, that they had voted to buy the plant back in February, 1980, the jury was not bound to believe them. At the time that the directors were deposed, they were being sued by the trustee, and it was

then in their interest to push the date of acquisition "as far back as possible." As the defendants were able to show on cross-examination, gasohol was a "darned good idea" in 1979. A person was a "national hero," as one witness put it, if he built a gasohol plant in early 1980. As time wore on, however, such an investment got more and more "chancy." At some later point, an acquisition by the Co-op began to take on, more and more, the odor of a fraudulent white elephant foisted off onto deluded farmers. Jack White's ingenious explanations of concealed titles and hidden minutes, given in advance of everyone else's depositions, let everybody off the hook. By the time plaintiffs made their settlements with the directors, the directors were "locked into" testimony which the jury may in fact have disbelieved. They may, instead, have chosen to credit the testimony of Larry Heatherrington, a nonparty, who swore that no final action was taken at the May, 1980, meeting. The fact that some action was even contemplated in May (an assertion corroborated by Neidecker) gives the lie to a vote to buy taken earlier in February. Quite simply, the court believes that a reasonable jury could have concluded that the "done deal" never was. If, before this lawsuit was filed, one had asked directors whose memories had not been "refreshed" by White's deposition, just when the gasohol plant was bought by the Co-op, one might very likely have come up with different accounts. If one were curious as to whether White could have enforced a contract *against* the Co-op as of November 25, 1980 (certainly one index of a "done deal,") one might very well have concluded that the deal was very much up in the air, no terms, no writing, no certainty.

Because a reasonable person might conclude that there was "no done deal," it is clear that the only way that the transfer was finalized was through the chancery court lawsuit. The following evidence supports a conclusion that defendants Ball and Mourton substantially assisted the consummation of the transaction. First, they suggested the means by which the transaction might be consummated. Second, they amended the complaint to add a term absent in the first draft. (This evidence is not mere "impeachment" evidence as defendants suggest [Brief at 30], but, being an admission of a party opponent, is substantive evidence.) Finally, they presented the materials to Creekmore for presentation to the Board at its December 11, 1980, meeting. Short of manually taking the papers and the witnesses to court and personally filing the papers with the clerk, it is hard to conceive how much greater assistance could have been given. As we have said, defendants' suggestion that the White Flame *stock* be transferred, rather than its assets, was the *sine qua non* of a securities transaction. We have today expressed our reservations concerning whether securities laws were meant to reach such activities. Our reservations on this point are of the same water as those Mr. Justice Stevens expressed in his dissent in *Landreth v. Landreth Timber Co., supra*, at 2312, 2313. We have to conclude that inasmuch as the declaratory judgment action constitutes a "disposition" of a security under the broad statutory language, the assistance given to the parties by defendants Ball and Mourton was substantial. Every case must be decided on its own facts. Some securities are sold in the market, and a lawyer's involvement in such sales may well be minimal. But where shares are disposed of through the courts,

the same lawyer's involvement will likely be central. Other than remarking on the incongruities presented by the application of the securities laws to cases such as this one, we can only say that it is for the legislature to act to correct them, and not for us.

Finally, there is the question whether there is sufficient, substantial evidence of *scienter* upon which to ground liability *vis a vis* Ball and Mourton. It would be pointless to exhaustively detail all the testimony relevant to this issue given during fifteen days of trial. The jury was presented with two versions of the November 25, 1980, meeting, one of which said only White was present (Creekmore and Brewer deny having been there, Hardin and Kuykendall don't recall anyone other than White,) another which says that White was accompanied by the Board's president and its general counsel who "laid out the facts." If it were true that only White supplied the information, one might reasonably conclude that "taking White's word for it," with no investigation, constitutes an extreme departure from the standard of care exercised by a lawyer. There is other evidence in the record – the testimony of Kershen, for example, to which the jury may have given more credit than they did to that of Brill – which helped define the standard of care. The jury also observed the standard of care (coincidentally, in a securities transaction) followed by Messrs. Patton and Russell of the Friday firm, and could draw its conclusions accordingly. The court's task is not to substitute *its* opinions and judgments in place of those of the jury where there is substantial evidence in the record upon which the jury could ground its conclusion. The court believes that there is substantial evidence upon which the jury could find by

a preponderance of the evidence, conformably with the instructions, that defendants acted with the requisite *scienter*.

The court is, however, convinced that the jury erred in assessing damages in the amount of $2,732,000 as a result of the securities fraud. The court would first note the congruity between the jury's findings of damages and the plaintiffs' "damages" exhibits. The trustee claimed $1,985,000 in damages against Arthur Young, and the jury awarded precisely that amount. The class claimed $6,121,652.94 in damages against Arthur Young, and the jury awarded precisely that amount as well. The trustee claimed that if one were to assume that the securities fraud began on November 24, 1980, and continued to April 22, 1982, the Co-op lost $4,232,000. The damages found by the jury were *precisely* $1.5 million less than the total amount of damages claimed by the Trustee. Regardless how one chooses to deal with the myriad figures in this case, the correspondence is remarkable.

The court instructed the jury to find the "real value" of benefits lost by the Co-op "in connection with" the sale or "other disposition of" White Flame Fuels securities. The court does not recall any objection to that instruction from any source. This damage instruction differed from that offered under the "actual fraud" count of the complaint, which was measured by the fair market value of the rights given up by the Co-op, minus that which it received in return, to all of which was to be added any consequential damages occurring up to the time at which the fraud was or should have been discovered. Again, the court recalls no objection to this instruction from any source.

In examining the differences between the two instructions, we first note that under the securities laws instruction, we asked only that the jury determine the fair value of what the Co-op "gave up" through the declaratory judgment action, undiminished by whatever they "got in return." Under this construction, the gasohol plant was a "washout," not counted in raising or lowering the damages. The Co-op held $4.2 million of White's obligations, and he had the plant plus other personal assets with which to satisfy the guarantees. The evidence showed that if the Co-op had commenced diligent collection procedures on November 24, 1980, they would have received some but not all of the $4.2 million back. The jury was asked to determine what, if anything, they "lost" by taking the stock and cancelling the notes.

The evidence showed that *at most*, the Co-op could have liquidated $1.5 million of White's property, and would have saved an additional $250,000 that the decree ordered the Co-op to pay Citizens Bank. This is the rosiest picture imaginable for the Trustee. In all likelihood, if the Co-op sued White, he would have filed a bankruptcy, and the Citizens Bank would have shared in his estate. But no matter. The defendants put on no evidence to contradict or vary these figures, although undoubtedly appraisals done of White's property would have been much lower. One remembers that White's "financials" were prepared in order to get loans, and in such situations it is not unusual to find that people falsify information to paint a better picture of their net worth. White, in fact, was convicted in this court for doing just that nine months before the trial began.

At the very most, then, the Co-op would have gained $1.75 million by liquidating White's estate. Adding a plant valued at $1,000,000, and tax credits worth $800,000, the Co-op would have realized, theoretically, a total of $3.55 million by taking immediate action to collect and foreclose. As matters happened, the Co-op "lost," at most, $1.75 million, because they received, in return, only the plant and its credits.

Another difference between the "actual fraud" instruction and the "securities fraud" instruction was the availability of consequential damages under the former, and their absence under the latter. Consequential damages are not available under the state law claims, Ark. Stat. Ann. § 67-1256(a), and are available under Federal Rule 10b-5 claims in limited circumstances. The trustee neither pleaded nor justified a claim for consequential damages, and so the jury was not instructed to find any. Again, no one objected to the damage instruction as given.

Taking the figures given by the trustee constituting "all the losses" sustained by the Co-op from November 24, 1980, the following figures appear (Plaintiffs' Exhibit No. 1000):

1.	Jack White's net worth	$1,500,000
2.	Proceeds from sale of gasohol plant	1,000,000
3.	$250,000 paid to Citizens Bank	250,000
4.	1981 loss on gasohol plant	1,300,000
5.	1982 loss through 4/82 on gasohol plant operations	182,000
		$4,232,000

Items No. 4 and 5 *may* be recoverable in an action involving actual fraud, but not securities fraud. Item No. 2 is duplicative since the undisputed facts are that the Co-op acquired title to the plant. They "could have" gotten $1,000,000 for selling the plant because they owned it. They cannot keep the plant *and* claim damages for what they would have gotten if they had sold it. The maximum amount of damages which the Co-op can prove, then, is $1,750,000, and that is a *very* generous measure, computed on Jack White's March 1, 1981, financial statement, the credibility of which is certainly open to question.

The plaintiffs suggest that in addition to the damages listed in Exhibit 1000, there was the $200,000 or so in life insurance, etc., that the Co-op paid out to White in 1982. The argument goes that "but for" the declaratory judgment suit, the Co-op would have retained these moneys in satisfaction of the judgment they would have obtained against White. The declaratory judgment action did not require the Co-op to disburse these moneys, though. Furthermore, there is not a shred of evidence in the record that Ball *or* Mourton knew about these moneys. The Co-op disbursed these moneys in transactions separate and apart from the White Flame matter over a year later. At the very most, these damages are consequential; furthermore, they are so remote as to be not recoverable in a securities action. In any event, consequential damages must be proved to have been caused by the fraudulent transaction with a "good deal of certainty." *Zeller v. Bogue Elec. Mfg. Corp.*, 476 F.2d 795, 803 (2d Cir.), *cert. denied*, 414 U.S. 908 (1983). No such certainty attends the trustee's prayer for "business losses" and other payments to White. The Co-op essentially made a gift of its assets to

Jack White in 1982. Such an act, done a year after the transfer or other disposition of the securities, cannot reasonably be said to have been even foreseeable, much less proximately caused by Ball and Mourton.

We would also make an additional observation. The damages which the Co-op sustained from the operation of the gasohol plant would have been recoverable in an actual fraud claim, but only up to January 26, 1981. At that point, the December 19, 1980, decree was filed for public record in the Crawford County Courthouse. In Arkansas, a defrauded party is deemed to have constructive knowledge of all matters filed for public record. *Hughes v. McCann*, 13 Ark. App. 28, 678 S.W.2d 784 (1984). In addition, one's ability to recover damages for fraud is foreclosed for any period after actual or constructive discovery. *Danielson v. Skidmore*, 125 Ark. 572, 189 S.W. 57, 58 (1916). The consequential damages recoverable at common law, then, would have been those for the operation of the plant from December 19, 1980, to January 26, 1981, a little over a month. We cannot believe that the consequential damages recoverable under the securities acts would exceed those recoverable at common law, even if the proximity of the damage were otherwise proved to the jury. We do not know what losses were suffered by the plant in this five-week period, and decline to speculate. Suffice it to say that we do not believe that such consequential damages are collectable under the securities laws, and that even if we did there is no evidence that any losses were sustained during that particular period, even though losses for the gross sixteen-month period following the chancery court lawsuit were otherwise adequately shown.

In this connection, Ball and Mourton have attacked the trustee's proof of damages, asking for a new trial because the court permitted Thomas Robertson to "testify" as to that matter. The court observes first that Robertson "summarized" materials already in evidence. Exhibit 1000, introduced through Robertson, incorporated, relevantly, Exhibits 29, 102, 181 and 182. He really added nothing to the case, nor offered any opinions, not otherwise exposed to the jury in documents or witnesses as to whom and which there were no objections. If any error was made, it was doubtless harmless.

We believe, moreover, that no error was made. Thomas Robertson was no "stranger" to the suit; he was a party. As bankruptcy trustee, he came into possession (for the benefit of creditors) of all the "property of the estate" including rights of action. 11 U.S.C. § 704(3). He is not unlike an owner of the property, or the trustee of a trust, and the law liberally allows parties, owners, and trustees to testify about the "value" of property, even though they are not "experts," "appraisers," and so on. Even non-parties who have looked at property with an eye towards buying it have been allowed to express an opinion on its value. *See Chunn v. London & Lancashire Fire Ins. Co.*, 124 Ark. 327 (1916). We see no error in the proceedings and certainly no reason to order a new trial.

Finally, the trustee has asked that judgment under Count IV be amended to award the plaintiff $250,000 rather than $51,800. The argument runs that since the jury affirmatively answered the first interrogatory under that claim, they were bound to award *all* fees paid to Ball and Mourton, undisputably ranging upwards of $250,000 or so. The first interrogatory asked the jury to determine

whether Ball and Mourton "represented conflicting interests between May, 1977, and March, 1982. . . . " The plaintiff takes this question as asking, and the jury to be answering, that Ball and Mourton represented conflicting interests *at all times* between May, 1977, and March, 1982. That is not the case, however. If the court were to have asked the jury if World War II happened between 1920 and 1950, the jury could correctly answer "yes" even though the conflict began in 1939 and ended in 1945. The court additionally instructed the jury that if they found that Ball and Mourton represented conflicting interests, then they "must award a judgment based on the total amount of fees and expenses collected by Ball and Mourton from the Co-op *during the period of time* in which the conflict existed." (emphasis added). The jury could have determined that the conflict began on November 24, 1980, and ended December 19, 1980, and that Ball and Mourton did not represent conflicting interests at any other time. Of course, we do not know just when the jury found that the conflict began or ended. That circumstance moots Ball and Mourton's argument that the judgment should be amended because the fees were paid outside the period established by limitations. They bear the burden of proof on that point, and cannot establish it on this record.

Accordingly, the court will order a remittitur of $982,000 with reference to damages claimed by plaintiffs under their securities fraud claims against Ball and Mourton, or will order a new trial. If the plaintiffs accept the remittitur, judgment will be entered against Ball and Mourton in the amount of $1,801,832, subject to credits, *see, infra,* Part C.

C. The Issue of Credits Against the Verdict

Whether the verdict against Ball and Mourton (and, by analogy, against Arthur Young) should be reduced by amounts received in settlement from other defendants, is the subject of our inquiry in this section. On October 10, 1986, the court scheduled a hearing at Arthur Young's request, to determine whether the trustee and the class should be required to allocate between themselves some $8.2 million in settlements made with them jointly by the directors and officers, and certain auditors and attorneys. At one level, the court was concerned with fairness, and used a "checkerboard" analogy to express its feeling that several plaintiffs ought not be able to sue several defendants, get a verdict, and then allocate the settlements in such a way as to artificially deny to the defendants the benefit of credits which the law would otherwise allow to them. At a deeper level, the court desired to know whether the class was to have some definable share of a fund which otherwise was escrowed to it and the trustee without differentiation. The court could foresee a possibility, for instance, that the trustee might receive no recovery, and the class a large one. If allocations were to be made after such a verdict, plaintiffs *as a whole* would be better off to allocate all settlements to the trustee. If the judgment were affirmed, the plaintiffs would reap something of a bonanza.

Such a choice would, however, throw the full weight of the risk of reversal on the shoulders of the class. If the judgment were reversed for any reason, the class would be set back on Square One. They would lose their right to a separate recovery not only from Arthur Young, but also

from those defendants, principally the directors, whom they covenanted not to sue. True enough, they would not have been total losers. The estate would have been augmented some several millions of dollars after fees and expenses were taken out, but the class would participate in the estate only as unsecured general creditors, in common with everyone else. It is unlikely that they would enjoy a "dollar for dollar" recovery, or anything near it. That would have troubled this court greatly, especially since, four months previously, we decided that certain members of the class were entitled to recover from the directors and from White an estimated $4.8 million, plus interest and attorneys' fees. Anyone can appreciate the profound due process problems which would attend an allocation skewed in favor of the trustee in that context.

The court was therefore gratified that the trustee and the class made what appears to be a fair and rational allocation. Knowing that such a decision is a hard one to make when one faces what plaintiff's counsel described as "the crapshoot" of a jury verdict, we attempted to ease the plaintiffs' fears on this point by permitting the allocation to be made after the court issued its opinion on the defendants' motions for summary judgment. Some measure of the rationality of the plaintiffs' ultimate decision on the matter of allocation is that no defendant to this point has attacked it, even though Arthur Young, certainly, had and has a motive for suggesting that the class receive more from the division. As we understand matters, the plaintiffs decided that of the $8.2 million received in settlements as of October 16, 1986, $5.6 million should go to the class and $2.6 million to the trustee.

Settlements were made with the directors and officers, auditors and attorneys (Kuykendall, Moody, Creekmore and Harriman) to extinguish, by virtue of "covenants not to sue" all common law, state and federal causes of action asserted against them, whether by the trustee, the class, or both. The state law claims included, basically, common law claims for negligence and fraud, and blue sky claims for securities violations. The federal claims embraced the securities laws, and also R.I.C.O. There is, theoretically, a possibility that two different contribution standards might apply to our question. Rather than treat that question directly and immediately, we will first address state law concerns.

Settling defendants reached an accord with plaintiffs leading to a dismissal of all common law and statutory claims against them. Of particular interest in this connection is the trustee's claims under the common law and the blue sky law against Ball and Mourton: can Ball and Mourton, who were alleged and found to have caused but a fractional part of all damages suffered by the Co-op at the hands of all the defendants, assert any right to set-off under Arkansas law? The court believes that the answer is yes.

First, the Arkansas Securities Act states explicitly that nothing in the statute is meant to abridge rights or remedies otherwise provided by law. Ark. Stat. Ann. § 67-1256(h). We conceive this to mean that if a defendant against whom a verdict is given has rights otherwise under the law to a set-off or credit for amounts otherwise taken in by settlement, then the blue sky law could incorporate those rights and procedures as well. That is, if

section 1256(h) is solace to plaintiffs, it is solace to defendants as well. Furthermore, section 1256(b) relates that contribution is available as in cases of contract. Although we recognize that, strictly speaking, a request or motion for a credit is not an action for contribution, *per se,* it is sufficiently "contribution-like" that the Uniform Contribution Among Tortfeasors Act, § 4, Ark. Stat. Ann. § 34-1004 (1962 Repl.), treats credits for settlements previously reached *in pari materia* with rules and procedures governing active contribution.

The Arkansas Contribution Act is a prolific generator of nice questions, at least in the Arkansas courts. Quite early on, the Arkansas Supreme Court expansively interpreted the term "joint tortfeasor" to embrace not only those concurrently negligent, but those who acted several months apart to contribute to the "same injury." *Applegate v. Riggall,* 229 Ark. 773, 318 S.W.2d 596 (1958). In *Applegate,* a plaintiff sued Dr. Applegate, a physician who allegedly negligently performed surgery upon her, with the result that she was ultimately required to employ Dr. Riggall to remove her kidney. Applegate denied negligence and claimed that Riggall should contribute to any judgment since Riggall had negligently come to the conclusion that the kidney required removal. Riggall demurred, claiming that he was not a "joint tortfeasor" under those facts, and the trial court agreed. The Supreme Court reversed, saying:

> Let it first be said that it is not necessary that the parties act in concert in order to be liable as joint tortfeasors, and appellee concedes this to be the general rule. *See Giem v. Williams,* 215 Ark. 705, 222 S.W.2d 800. The sole question is simply

> whether Dr. Riggall is a proper party defendant in this case. Appellee argues that the two doctors cannot be held to be joint tortfeasors, because any injuries received from either by plaintiff were separate and distinct injuries; that under the law, tortfeasors, acting independently, are jointly liable to plaintiff and liable to each other in contribution, only when the independent acts of each, cause or contribute to the same injury sustained by the plaintiff. . . . While it is true that a part of plaintiff's complaint deals with alleged injuries occurring before Dr. Riggall entered the picture, nonetheless it is apparent . . . that a substantial part of the damage complained of was allegedly caused by the loss of the kidney. In other words, the suit is based on *all* the injuries received by plaintiff. . . .

Id. at 775-76.

Arkansas appears to take the singular view that successive, independent tortfeasors are to be considered "joint tortfeasors," a matter recently noted by the Eighth Circuit in *Merrill Lynch v. First National Bank of Little Rock,* 774 F.2d 909, 916 (8th Cir. 1985). *Merrill Lynch* understands *Applegate v. Riggall, supra,* to repudiate the position taken by other courts, *viz., Lasprogata v. Qualls,* 397 A.2d 803 (Pa. 1979), that one who aggravates an earlier injury, is *not* a joint tortfeasor with a party who caused the original damage. *Id.* at 805. As a consequence of its decision, the *Lasprogata* court determined that under the law it was required to *apportion* the damages as between the two separately negligent acts, and that the rules of contribution did not apply. Having noted Arkansas' singular posture on the issue, *Merrill Lynch, supra,* applied an

expansive notion of "joint tortfeasor," (one which examines the gross injury complained of, rather than the acts which cumulatively caused it,) and held that a business which engaged in a check-kiting scheme was jointly liable with a bank, in an action in which the plaintiff claimed that the bank wrongfully chose to conceal from it information which would have led the plaintiff to discover the "kite" on its own. In examining the Arkansas precedents, the Eighth Circuit concluded that "if one tortfeasor is sued for a loss which is partly the fault of another, then he is entitled to contribution or indemnity." *Id.* at 917.

A consequence of finding that a defendant is a "joint tortfeasor" with another is that the rules of contribution come into play, one of which is that any amounts received in settlement by another tortfeasor are applied *at least* dollar-for-dollar against any verdict awarded against non-settling parties. Ark. Stat. Ann. § 34-1004 (1962 Repl.). Our case is "queer" because the trustee settled with the "deep pockets" (the directors) having the more expansive liability (one starting in 1979 and continuing into 1984, rather than, as in the case of Ball and Mourton, one commencing late in 1980 and concluding shortly afterwards in 1981,) and the greater resources for satisfying it. Such a circumstance does not in our mind justify a departure from the rule. That is, simply because one party, in the minds of the plaintiffs, has obstinately refused to contribute to a settlement fund does not mean that he forfeits all the rights the law gives to non-settling tortfeasors. Manifestly, the statute comprehends that certain defendants in multi-party cases can exploit "game theory" and ruin the day for everyone. Perhaps it would be better policy to deem them not to be "joint

tortfeasors." To reach a result which serves the "better policy" would require us to ignore *Riggall*, and the Eighth Circuit, which has so recently applied the Arkansas authority, could hardly approve of our handling of it.

There is no warrant in the statute arbitrarily to decide that the $2.6 million allocated to the trustee was for damages occurring "after" Ball and Mourton's liability concluded. Rather, the trustee settled with such parties for the Co-op's "injuries," the largest part of which included the transfer of the gasohol plant and its *sequelae*. We are confident that the trustee believed that he could recover upwards of $6 million against Ball and Mourton on his common law fraud claims. (Exhibit 1000, Part B). He failed to do so. We cannot imagine that there would have been any serious objection to crediting the $2.6 million in settlements against the $6.0 million verdict. That would clearly follow from the statute. We cannot see that plaintiff's lack of success in this particular should require the court to vary the statutory warrant to permit him a greater net recovery.

We decide, therefore, that the awards against both defendants made under the Arkansas Securities Act and common law are subject to *pro tanto* reductions; that is, that the $1.8 million verdict against Ball and Mourton, $1.75 million of which carries a statutory award of interest and attorney's fees, shall be reduced by a $2.6 million credit (at least conditionally, pending outcome of the settlement hearings before the bankruptcy court). Also, the $6.1 million class judgment against Arthur Young, plus interest and fees, shall be reduced, conditionally, by the $5.6 million taken in by the class.

The question is different with respect to the federal securities laws. Do they incorporate singular state common law contribution doctrines, ones which hold tortfeasors acting many months apart to be "joint," or do they enforce their own standards? That is, do the federal securities laws regard situations such as Ball and Mourton find themselves in to constitute an "indivisible injury," or is a federal securities violation a *distinct* injury such as requires an apportionment of settlement amounts? *See, e.g., Mackethan v. Burris, Cootes & Burris*, 545 F.2d 1388 (7th Cir. 1976), *cert. denied*, 434 U.S. 826 (1977). *Mackethan* does not solve this riddle; it merely poses it. Federal courts confronted by this teaser have repeated the old common law nostrum that "a party is entitled to but one satisfaction for a single injury. . . ." *Ratner v. Sioux Natural Gas Corp.*, 719 F.2d 801 (5th Cir. 1983). The trick, of course, is to determine whether the federal securities laws regard the events beginning in June, 1979, and continuing on through February, 1984, to be indivisible. We can only hold, consistently with our October 15, 1986, opinion on defendants' motions for summary judgment, that they do not.

The parties will recall that it was the plaintiffs' position, or at least the trustee's, that Ball and Mourton had entered a stream of fraud against the Co-op, and that under the securities laws, they were responsible not only for such out-of-pocket depletion of the Co-op's treasury as the chancery court action might have caused, but also such acts of mismanagement occurring thereafter consequential to it. We read, after some considerable study, Rule 10b-5's "in connection with the purchase or sale of a

security" requirement as divorcing acts of corporate mismanagement anterior and posterior to a securities transaction from the coverage of the statutes and the rule. Briefly, there has been "a debate" among practitioners and scholars as to whether the federal securities laws should be read to provide plaintiffs with a general warrant to search for and seize upon corporate mismanagement and breaches of fiduciary duties affecting the value of securities, and to redress them under the *aegis* of a 10b-5 action. The ultimate result of such a holding would be to construct a federal law of corporations governing all kinds of matters touching corporate governance, shareholder director and shareholder-shareholder relations. We believe that the Supreme Court, without addressing the issue *per se,* restrictively interpreted the securities laws so as to exclude from their ambit questions concerning intra corporate management. *Sante Fe Industries, Inc. v. Green,* 430 U.S. 462 (1977). Even the most zealous proponent of expansionist interpretation, William O. Douglas, writing as a commentator before he ascended the bench, described the 1933 Act as limited in its scope:

> As Berle has said, the Securities Act, though probably one of the most spectacular types of legislation, is of secondary importance in a comprehensive program of social control over finance. . . . There is nothing in the Act which would control the speculative craze of the American public, or which would eliminate wholly unsound capital structures. There is nothing in the Act which would prevent a tyrannical management from playing wide and loose with scattered minorities, or which would prevent a new pyramiding of holding companies violative of the public interest and all canons of sound finance. All the Act pretends to do

> is require the "truth about securities" at the time of issue, and to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor.

Douglas and Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171 (1933). As we see, the federal statutes were geared towards specific behavior and the losses which flowed to the investor from it, not towards the generality of losses that may befall the investor in securities, arising out of mismanagement or oppression.

Arkansas' tort scheme, especially when seen through the lens of *Applegate v. Riggall, supra,* emphasizes compensation far more strongly than deterrence. The Arkansas courts, in striking the balance between two principles – one, that a party receive but one satisfaction for his loss, and the other that all tortfeasors should bear a responsibility in damages for the loss which he caused, *e.g.*, Prosser, *Law of Torts*, § 50 at 307 (4th ed. 1971) – has cast the balance decidedly in favor of the former in *Riggall*. A *pro tanto* credit given to one of a number of successive, but deemed to be "joint" tortfeasors, for amounts taken by plaintiff in settlement, will distribute burdens inconsistently with the promotion of a deterrence policy.

At the same time, the deterrence goal of the federal securities laws can be overstated. If deterrence were as important to the federal scheme as plaintiffs might suggest, punitive damages would be more freely available against securities violators. *But see Meyers v. Moody*, 693 F.2d 1196, 1220 (5th Cir. 1982), *cert. denied*, 464 U.S. 920 (1983). The securities statutes from which Rule 10b-5 springs limits one to a recovery of "actual damages." Securities Exchange Act of 1934, § 28(a). Furthermore,

interest awards under 10b-5 are discretionary, *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 412 F. Supp. 45, 61 (E.D. Mo. 1976), *rev'd on other grounds*, 562 F.2d 1040 (8th Cir. 1977), *cert. denied*, 435 U.S. 925 (1978), as are attorney's fees. Deterrence is an important policy of the securities laws, important enough, we conclude, that a party found to have violated the law should not receive a full *pro tanto* credit from settlement amounts given for releases from claims fully embracing but far more extensive than the securities violation.

We believe, therefore, that the amounts taken in settlement should be ratably reduced so that a partial credit, although not an entire one, can be taken against the securities verdict. The jury, being deliberately kept ignorant of the amount and allocation of the settlement at plaintiffs' request, could not, of course, have assisted us in our inquiry. Had the jury been informed of the amount and allocation, presumably they could have given a verdict for any amounts above those already received in settlement, as is done in the state courts. *Giem v. Williams*, 215 Ark. 705 (1949).

The settlements with the trustee tacitly acknowledged some degree of "fault" for the Co-op's loss – at least to the extent that courts recognize that such payments are not "gratuities," a characterization which would summon application of the "collateral source rule" and deny *any* credit for amounts taken in settlement from other parties. *Snowden v. D.C. Transit System, Inc.*, 454 F.2d 1047, 1049 (4th Cir. 1976). It is not apportionment of fault with which we are concerned, but the *attribution* of a part of a larger amount paid to settle a gross injury which

includes damages wrought by all the defendants – settling and non-settling alike – as a credit against a smaller amount assessed by the jury against one actor in a chain of tortious circumstance. In federal securities cases, the court is given some discretion in this matter. *Sirota v. Solitron Devices, Inc.*, 673 F.2d 566 (2d Cir. 1982). Where the court makes an attribution of this sort, the question becomes which method to use. Manifestly, attribution serves both policies of the federal securities laws – compensation and deterrence – and is therefore superior to a *pro tanto* credit, which ill-suits the deterrent policy of the law, and to a policy allowing no credit at all, which permits a plaintiff ultimately to recover *more* than his actual damages for a securities violation. It is to be observed that in this case, assuming a remittitur is accepted, the verdict amount is the maximum possible allowable under the evidence and the instructions pronounced and agreed upon by the parties, both trustee and defendant. The 10b-5 action against Ball and Mourton was concurrently pressed against the directors, Creekmore, the auditors, and certain "inside" employees, and cannot be said to have had *no* effect in inducing them to settle as generously as they did. In fact, as far as it goes, the "blue sky/10b-5" action was practically the only one still on the board against Creekmore, although his settlement ran to both the trustee and the class, and comprehended claims in addition to those asserted for fraud and securities violations. It is impossible to judge just what effect the presence of these claims had on the decision to settle. Hindsight based on the jury's verdict would indicate that the influence may have been considerable, or should have been. But hindsight availeth us naught.

We conceive that there are at least three possible ways to perform an attribution. The first would be for the parties to have assessed a settlement amount for each claim. Ball and Mourton gave releases to Moody, for example, and in return for which they expected to get a *pro tanto* discharge from their liabilities therein. The "release" of Moody by the trustee and the class did not differentially specify the claims released and the consideration therefor, but rather discharged in gross all liabilities Moody had to the trustee and to the class. Releases not restricted to particular demands or claims ordinarily cover all claims then due. *Daniels v. Tip Top Plumbing & Heating, Inc.*, 409 S.W.2d 741 (Mo. 1966). It is certainly within the plaintiff's power to denominate what *claims* he is releasing in a multi-party case. *E.g., Swope v. General Motors Corp.*, 445 F. Supp. 1222, 1227 (E.D. Mo. 1978), and presumably for how much. If that were done, the court's task would be much easier. The amounts segregated as to *claim* could simply be applied *pro tanto* against the verdict. It is unlikely that this is a realistic alternative. Parties settle *lawsuits*, not separate claims. It would hardly promote the settlement process, for example, to encourage or require parties to allocate gross settlement amounts among negligence, warranty, or strict liability claims.

A second alternative would be to apply a *per capita* reduction of settlement amounts, and apply the balance against the verdict. For example, if five parties were involved in a securities claim and four "settled," four-fifths of their settlement amount could apply against the verdict. The argument might run that the securities statute permits "contributions as in cases of contract," which

is *per capita*. We find persuasive, however, the reasoning of *Gould v. American-Hawaiian Steamship Company*, 387 F. Supp. 163, 170 (D. Del. 1974), which declares that the Congress did not intend that aspect of contract law to take its place in securities regulation. It is also defective as applied to our case since it applies arbitrary numerators and denominators to a question of credit against a verdict, where the settlement in question was reached for claims and damages distinct from and exceeding that awarded for the securities violation. In addition, simply because a statute speaks in terms of *pro rata* contribution, it does not follow that such contribution be *per capita*, but may also bear on the amount of consideration paid. *Lahocki v. Contee Sand & Gravel, Inc.*, 398 A.2d 490, 573, *rev'd on other grounds*, 410 A.2d 1039 (Md. 1979).

A more *rational* way of dealing with this problem is to take the *total* damages suffered by the trustee as a denominator, the numerator being the verdict assessed against the non-settling defendant, and *multiply* that fraction against the amounts gathered in settlement to arrive at the credit against the verdict. The total settlement of $8.4 million has been allocated on basically a 5.6:2.6 ratio between the class.[1] After October 10, 1986, the trustee and class received a $75,000 settlement from Creekmore, and the trustee alone a $40,000 settlement from Farmland. Thus the *total* amount due the trustee alone from which an attribution might be made is $2.692 million

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[1] Since the allocation was made, the plaintiffs settled with Creekmore, White and Brewer, but we have not included these in the ratio.

([2.6/8.2 x 8,362,000] + $40,000). Of that amount, a certain percentage is attributable to the securities violation in the White Flame transaction. In a personal injury case it might be more "daunting" to fix the proper "denominator" for our ratio: there are intangibles to consider such as pain and suffering. Here, however, the trustee showed (and the evidence justified) that the Co-op's total damages were $7.9 million (Ex. 1000) starting from 1979 and continuing through to the filing of bankruptcy. Using that as our denominator, it appears as if some $613,000 should apply against the verdict. In a case where no releases had been exchanged among the several defendants, this would be the proper computation.

There are, however, two separate kinds of releases here. The first is "straight forward" and provides that all amounts received thereunder shall apply "dollar for dollar" against the verdict. These releases, from Moody, Kuykendall, Citizens Bank, Creekmore and Harriman, and Farmland, White and Brewer, amount to $1,702,000. We have no choice but to apply the *full* amount due the trustee on the 2.6:5.6 allocation towards the verdict he received. That is, from those amounts $539,656 applies *pro tanto*.

The settlement with the directors is different. It applies a *pro tanto* reduction *only if* the verdict is tripled. The verdict, of course, was not tripled. Instead, therefore, that a ratio of the settlement apply *pro tanto* through the release, the trustee's portion of the directors' settlement should be multiplied by the ratio of verdict to total damages and applied against the securities claim. This amounts to $491,000, which, when added to the other amount produces a total credit of $1,030,656 against the

judgment. The $51,800, being a state common law claim, is reduced *pro tanto* without attribution or reduction, but only if there are "unused" credits on the securities claims. Judgment shall enter for the trustee on his 10b-5 claim in the amount of $719,344, if remittur is accepted.

Interest is discretionary in 10b-5 cases. *Huddleston v. Herman & MacLean*, 640 F.2d 534, 560 (5th Cir. 1981), *modf'd on other grounds*, 459 U.S. 375 (1983). For the following reasons, we believe that it should not be granted on the full amount of the verdict against Ball and Mourton. First, the verdict given is the maximum possible which the trustee could have gained. It assumes the truth of the following: First, that White valued his assets at "market"; second, that if the Co-op had moved against his assets starting on November 24, 1980, it would have achieved a full $1.5 million recovery. Given that White, or indeed anybody, could have litigated the question, converted non-exempt assets into exempt ones in the meantime (homestead, life insurance, etc.) and filed a bankruptcy, it is quite unlikely that the Co-op could have achieved so healthy a recovery on its notes. The damages in this 10b-5 action were not "liquidated" in other words, and the award given represents not only a generous one under the facts, but also one which probably contains a sufficient "pad" to accommodate any accumulation of interest at 6% (the Arkansas presumed rate) over the six years since the transfer. We wish to reserve the question as to the amount of attorneys' fees, if any, for later proceedings, which can run concurrently with an appeal, on application by the parties. Our court of appeals prefers to dispose of all questions at one time, and since we can foresee that time for appeal may be lengthy enough

as it is, there is no need in protracting it by a half-year contest over fees. We would ask, therefore, that an appealing party move that the question be remanded to us for work in the meantime, since we understand that an immediate notice of appeal will be filed, which might otherwise oust us of jurisdiction. We will therefore order a new trial, or reduce the jury's verdict to $1,750,000 on the 10b-5 claim, subject to a $1,030,656 credit, conditional on approval of settlements and allocations.

D. Arthur Young's Motions Against Liability Findings Under the Securities Laws

The post-verdict motions of Arthur Young & Co. assert that it should have judgment notwithstanding the verdict on both the state and federal securities laws claims for the following reasons:

(1) With respect to the state securities laws claims, Arthur Young says that the state law is modeled on section 12 of the Securities Act of 1933, and that since it could not be liable under that section, it should be absolved of liability under the cognate state law. Also, under the state law, the plaintiff, claims Arthur Young, must affirmatively prove his ignorance of the untruth or omission, and for having failed to do so, the class cannot complain. Finally, Arthur Young cannot be secondarily liable for any violation by the Co-op since it is not specifically listed as a party *prima facie* liable pursuant to Ark. Stats. Ann. § 1256(b).

(2) With respect to claims brought under Rule 10b-5, Arthur Young claims that this court

> should enter judgment in its favor notwithstanding the verdict because it either owed no duty to the class or satisfied any duty which it owed. Arthur Young claims that it made no representation to the class at large, and that no one relied on any statement made.

In addition, Arthur Young claims that rescission is an improper measure of damages to assess against one not in privity with the buyer. Also, Arthur Young claims that no judgment was entered against any individual partner, and therefore none can be entered against the partnership. Finally, Arthur Young claims that it should have been granted instructions against the directors on contribution claims, and should have a new trial to assert such claims for contribution. By separate motion, Arthur Young claims that any judgment entered against it should be reduced by the amount already paid and allocated.

We shall address the foregoing, in roughly inverse order. We believe that any judgment entered against Arthur Young in favor of the class should be reduced *pro tanto* by amounts allocated and approved. The court is impressed by one feature of plaintiffs' 17-page brief in opposition to any reduction in the verdict: it failed to cite a single authority for any of its policy arguments. By contrast, the defendants have referred us to Arkansas statutory law, Ark. Stats. Ann. § 34-1004, which calls for a *pro tanto* credit. Other authorities have approved a *pro tanto* credit in federal securities law cases in appropriate circumstances. *See, e.g., Rolf v. Blythe, Eastman, Dillon & Co., Inc.* 570 F.2d 38, 49-50 (2d Cir. 1978). We do not believe that the fact that there were other members of the

class *as approved* has any bearing on the case. It is extremely doubtful that any "patronage dividend" obligees had any individual claims against defendants which survived the April 4, 1986, ruling on motions to dismiss. Furthermore, any liabilities owed by accountants and auditors with reference to demand note buyers purchasing notes before April 22, 1981, were satisfied in documents explicitly calling for *pro tanto* reductions. In short, we can find no warrant in law – other than a "policy" argument claiming that it is desirable to "punish" non-settlers by making class members more than whole – which would justify such an unprecedented action.

With respect to Arthur Young's claim that we wrongly denied it contribution on the class claims, we note that Arthur Young did not make a specific objection at trial concerning our failure to instruct the jury with respect to contribution from the directors on those claims. Furthermore, the instruction Arthur Young has included in its brief is an incorrect statement of the law. Such an instruction (for contribution) must assert the elements of the class's claim against the party from whom contribution is sought, since one cannot obtain contribution from one against whom the plaintiff has no cause of action. *Applegate v. Riggall*, 229 Ark. 773, 318 S.W.2d 596 (1958). A correct instruction would have directed the jury to find that the Co-op sold notes by means of a materially misleading statement, and that the defendants were directors of the Co-op, *unless* the jury found that at the time of the sale the directors did not know of the misstatements and could not have known of the misstatements in the exercise of ordinary care. In addition, it is hard to conceive,

for example, that "contribution" would have any effect at all on the amount which Arthur Young must pay. Somehow the directors, who only repeated what Arthur Young found, would have to be found more than 80% responsible (assuming a total verdict of $7,000,000) before it would have any effect on Arthur Young. In any event, we find that no error was committed because of Arthur Young's failure to object to our not giving an instruction on the class claim. Arthur Young cannot complain about any failure to give "Instruction W" (which, if proffered, was not done so on Thursday, November 13, or Saturday, November 15, and was therefore waived) since that instruction manifestly misstates the law. Finally, if an error was made, a new trial need not be ordered at this time since a right of active contribution arises only after a party has *paid* more than his "fair share." We believe, moreover, that it is highly unlikely that a jury can reasonably find that the directors were *more* responsible for the misstatements, when the jury found as a fact that the fraud "originated" with Arthur Young.

With respect to Arthur Young's claim that no judgment can be entered against it unless the jury found an individual partner liable, we make the following observations: First, Mr. Matson, as counsel for Arthur Young, did not object to the form of verdicts. We believe that the record will show quite the contrary, in fact. Second, defendants did not argue that the court's instruction about the liability of partners was in error. The authorities cited by Arthur Young are inapt, all as shown by the plaintiffs in their response. Naturally, derivative liability cannot be determined in the absence of a specific, primary liability. The jury was instructed that they must find

such primary liability. Everyone understood the instructions. If Arthur Young & Co. thought that it was prejudiced by the charge to the jury, and that under the charge Arthur Young & Co. could be held liable even where the jury found no fault or breached duty by any of its partners, the court would gladly have clarified such instructions. The record may show that we, indeed, did alter our charge on several occasions at Arthur Young's request. For example, our instruction on professional negligence was amended to add the proviso that "a good faith error in judgment is not negligent." There are other examples, of course, on both sides of the case. The point is, the court stood ready to change any erroneous instruction at the request or objection of any party. Arthur Young remained silent. We even understood Mr. Matson to say that it was not necessary to enter judgment against the individual partners (clouding title to their lands) since Arthur Young was good for the loss. We believe this objection to the verdict misreads the law, and has been waived by a failure timely to object to the instructions given the jury.

Having disposed of those questions, we will now treat Arthur Young's arguments concerning the state and federal securities laws, and the propriety of rescissionary damages in a 10b-5 case against an "aider-and-abettor."

E. Arthur Young and the Arkansas Securities Act

Arthur Young argues that since Ark. Stat. Ann. § 67-1256(a) is modeled on section 12 of the Securities Act of 1933, there can be no judgment against it on state law claims since its participation in the actual sales of the notes is too slight for liability under the federal law. *See*

Stokes v. Lokken, 644 F.2d 779 (8th Cir. 1981); and *Lane v. Midwest Bankshares*, 337 F. Supp. 1200, 1209 (E.D. Ark. 1972).

The interesting aspect to this argument is that section 12 applies by its terms only to "sellers," but that broader liabilities have been implied under the Act. Arthur Young seems to have suggested that liabilities cannot be implied against parties not named as presumptively liable under the state statute. However, their argument is considerably undercut by the fact that broader liabilities are freely implied under the federal laws. If, as Arthur Young suggests, the state law is modeled on section 12 of the Securities Act of 1933, then surely there can be no impediment in the language of the statute to an implication of liability against one not named as liable by the Act. Under section 12, for example, parties have been held to be sellers even though they did not "sell" the security, or control such a seller. Thus, brokers have been deemed sellers under the Act. *Cady v. Murphey*, 113 F.2d 988 (1st Cir. 1940), *cert. denied*, 311 U.S. 705 (1941). Courts have also found section 12 liability against those who, though not sellers, brokers, or controllers, "seduced the prey and led it to the trap," but did not spring the snare. *Lennereth v. Mendenhall*, 234 F. Supp. 59, 65 (N.D. Ohio 1964). To the same effect, *see Lawler v. Gilliam*, 569 F.2d 1283, 1287-88 (4th Cir. 1978); *Junker v. Crory*, 650 F.2d 1349, 1360 (5th Cir. 1981), and cases cited. In an enforcement action the Eighth Circuit forged a test more liberal than the "point of sale" or "proximate cause" test in an unregistered securities case. *Wasson v. Securities and Exchange Commission*, 558 F.2d 879, 885-87 (1977). It determined that a *non-*

selling broker could be suspended in a section 5 proceeding because of his "extensive role in facilitating the sale, because he was made aware of questionable circumstances surrounding the transaction which should have been investigated more fully and revealed in detail to his superiors, and because his position in the flow of information made his failure to fully investigate or disclose all the more serious." *Id.* at 887. *Wasson* does little more than erect a vigorous "but for" test of participation, specifically eschewing proximate causation required by *Hill York Corp. v. American Int'l Franchises, Inc.*, 448 F.2d 680 (5th Cir. 1971). *Wasson v. S.E.C., supra*, at 885. *Stokes v. Lokken, supra*, recognizes that section 12 liability can be applied against sellers and those in privy with the purchaser, and implied against those whose participation in the buy-sell transaction is a substantial factor in causing the transaction to take place. This is a long way of saying that the federal statute permits (and has done so for nearly 50 years) liability to be implied against parties who are not "sellers," including parties who would not be specifically designated in the blue sky laws.

Interestingly, it has come to our attention that the leading commentator on the securities laws has made approving reference to the very section of the *Restatement (Second) of Torts* to which we referred in our summary judgment opinion (section 876), as a fount from which secondary liability under an "aiding and abetting" theory might spring. Loss, *Fundamentals of Securities Regulation* (1983) at 1185 n.38. Professor Loss concentrates on section 876(b) of the *Restatement*, which speaks in terms of giving "substantial assistance or encouragement" to conduct.

Arkansas has explicitly held mere "encouragement" sufficiently tortious to make one jointly liable in negligence. *Cobb v. Indian Springs, Inc.*, 258 Ark. 9 (1975). The specific subsection which we employed, section 876(c), and on the basis of which we drew our instruction to the jury, requires a far stronger showing than mere encouragement and "substantial assistance." Taken by itself, one's act of "substantial assistance" may violate no duty to anyone. We required the class to show that Arthur Young's conduct, considered alone, violated a duty owed to them. That duty was the duty to refrain from fraud. At common law, an accountant or auditor has no duty to avoid negligence in the rendition of his services to his client, but may be liable to third parties for fraud. *Ultramares v. Touche, Ross*, 255 N.Y. 170, 174 N.E. 441 (1931).

To the extent that an argument against implication might once have been made in Arkansas, it has lost its potency since the General Assembly, in 1977, repealed that part of the Securities Act which forbade courts from creating liabilities not explicitly found in the statutes. The Uniform Securities Act, upon which so much of the Arkansas Act was based, declared in section 410(h) that:

> The rights and remedies provided by this act are in addition to any other rights or remedies that may exist at law or in equity, *but this act does not create any cause of action not specified in this section or in Section (e).* (emphasis added).

The draftsmen of the Uniform Act included the italicized clause in order to check the judiciary which, federal experience showed, had rapidly evolved private remedies perhaps unforeseen at the writing of the Securities Act of 1933, and the Exchange Act of 1934. The draftsmen said:

> A provision like that in the "but" clause appears in only a few statutes. . . . It is essential under a policy designed to make the civil liabilities as specific as possible. . . . And, as stated in the official comment, the mere presence of certain specific liability provisions in a statute is no assurance that other liabilities will not be implied, either on a tort or restitution theory. . . .

Loss and Cowett, *Blue Sky Law* (1956) at 395. The Legislature, as we say, repealed the "but" clause by Acts 1977, No. 493, § 16. There is, then, no legislative impediment to the implication of liability against Arthur Young.

Those "tort and restitution" theories to which the draftsmen alluded are longstanding in the common law. *Restatement (Second) of Torts* § 876 forbids one knowingly to assist another in breaching his duty to a plaintiff, or to breach an independent duty owed the plaintiff concurrently with the activities of a primary tortfeasor. Not as relevantly as section 876, *Restatement, Restitution* § 167, would, if implied, permit a plaintiff to recover from a person who neither sold nor controlled the seller of a security, but who *knowingly received* the proceeds of a corrupt bargain. Such a theory of recovery might permit one to be found liable even in the absence of "substantial assistance," but it would seem likely that recovery would be limited to the proceeds actually received, rather than the entire proceeds of the sale, consistently with other sections of the *Restatement*.

It remains for us to determine only whether under the peculiar facts of this case the common law of Arkansas would permit one to recover the amount of his

outlay because of fraudulent statements made to one with whom the plaintiff is not in privity. Nearly two centuries ago, in *Pasley v. Freeman*, 100 Eng. Rep. 450 (1789), the English common law took the tort of deceit out of warranty and permitted one to recover for fraudulently inducing the plaintiff to contract with a third party. Arkansas law, in a widely discussed case, permits one to recover not for fraudulent inducement to contract, but for fraudulently inducing a third party to breach a duty to the plaintiff! *Hendrix v. Black*, 132 Ark. 473 (1918).

Hendrix speculated in tax titles, and acquired one for some timberland, on the strength of which he extended a license to another to log the tract. The property was denuded of timber, and the owner of the freehold sued Hendrix for the damages done to his land. The tax title taken by Hendrix, it happened, was void. The court said:

> . . . it is obvious that if the appellant had made even the most cursory examination of the records he would have learned the facts connected with this tax title. The only fair and reasonable inference . . . is that he did not wish to do so. . . . His attitude would not have been so vulnerable nor his conduct so censurable if he had contented himself simply with buying and selling tax titles. . . .

Id. at 479. This case was appealed from a chancery court, which lacked subject matter jurisdiction over simple trespass actions at law. The gravamen of the complaint had to be in fraud, as to which equity has always concurring jurisdiction, and sometimes even exclusive jurisdiction. 19 Am. Jur. *Equity* § 39.

To the extent that a representation was made, the content of which was relied upon, it was made to a third party not involved in the *Hendrix* appeal, the logger. Had the logger alone been sued at law, he could not have defended an action of trespass on his belief that he had a proper license, although such evidence would have been relevant to a determination whether he should pay a penalty. *Caney Creek Timber Co. v. Steven*, 212 Ark. 759 (1949). Seemingly, if Hendrix had merely bought and sold his tax titles, he would not have been liable for his vendee's acts. Where damage to the freehold of the true owner was plainly foreseeable, and indeed was made nearly inevitable by the grant of a restricted license, the licensor owes a correspondingly greater duty to the foreseeable plaintiff. The cited passage from the case, *supra*, makes it appear that at common law a reckless representation made to a third party, even in the absence of a fiduciary or confidential relationship between the parties involved at suit, may suffice to impose liability on the speaker. The balance of the case makes it appear as if Hendrix and the logger colluded to trespass on the plaintiff's lands, and that the case sounds not in fraud but in some other action. Prosser, however, cites the case for the general proposition that one may be injured by fraudulent representations made by the defendant to a third party, *Prosser and Keeton on Torts*, § 105 at 725 (5th ed. 1984); and, of course, the subject matter jurisdiction in the *Hendrix* trial court was totally dependent on fraud.

One can scarcely reason from *Hendrix* and its broad liability holding and argue that the jury findings in this case represent the kind of behavior the common law would fail to sanction. The jury found that the fraud

originated with Arthur Young, and, certainly Hendrix was the author of the plaintiff's misfortune. Generally speaking, in securities cases, there is no requirement that aiders and abettors must *originate* a fraud. It is sufficient that they know of a primary violation and substantially assist it. Nevertheless, the court believed that the jury should be instructed to assign liability under the Arkansas Act only on a finding of origination for two reasons. First, if the fraud originated with the Co-op, Arthur Young might be held liable for "failing to discover a fraud," and this court was not prepared to expand the auditor's duty under the state law by that token regardless of the auditor's state of mind. We do not know what motivated Arthur Young to act as it did in this case, save to say that plaintiff has suggested some plausible ones. We do know that the jury found on substantial evidence that Arthur Young originated the fraud, and we may say that it was rather obvious that Arthur Young "struggled hard" to make the Co-op appear solvent, against all available data and any reasonable characterization of it.

Second, the Arkansas Securities Act is "status-oriented" rather than "scienter-oriented." It imposes sanctions upon those who "can control" regardless whether they do. When a corporation sells a security by means of an untrue statement, control can be exercised at two points: at the decision to sell, and at the decision to advertise or to make representations about the value of the security. If Arthur Young "originates" the material statements by means of which the securities were sold, it obviously has the power to "control" the content of those statements. The court believed that if the liability portion of the state Securities Act were to be made more flexible,

it should be done in a way that places such extended liability on a party which, in a very real sense, could determine, yes or no, whether a securities violation was to occur. This is yet another way of assuring that liability would not be placed on an auditor for a "reckless" failure to detect a fraud. In a sense then, the test we devised emphasizes "intent" and "control" and therefore will be applied (and we believe was applied) only in cases which clearly merit remediation at the hands of "third parties."

Foreseeability is obviously an important factor in a common law *Hendrix* case. Hendrix, of course, did not communicate with the victim; Arthur Young did. The jury was obviously able to draw conclusions about Arthur Young's role in the 1982 shareholders meeting. As we have said, it rather appeared as if the meeting were designed to forestall inquiry that would uncover the truth, rather than for any other reason.

We believe, therefore, that nothing in the federal securities act would forbid the implication of liability against Arthur Young under the state blue sky law; that any impediment presented by the statute was removed by the legislature; that assigning liability against Arthur Young was done on a basis consistent with the notion of duty to others to be found in Arkansas common law as well as consistently with the concept of "control" emphasized in the Securities Act; and that the jury was properly instructed in consideration of these premises.

Finally, the jury could find from the evidence that the class was unaware of the truth about the Co-op's financial condition. As we shall see, *infra*, at our discussion of 10b-5 liability, the legal theory operating in this case is

that Arthur Young committed fraud by failing to tell the directors and the class of certain facts. How can one "prove" that he didn't know of an *omission* to tell him something – or more to the point, *why should he have to* prove that he didn't know of the existence of a fact which was effectively concealed from him. What "good" would it have done if 50 or 100 members of the class took the stand? That would only mean that 1400 or so persons "failed in their proof." Burdens of proof have to be sensibly assigned, and there is no use in requiring thousands of people to "prove a negative," particularly where "common sense" tells one that some few investors would have closed their accounts down if they'd known that the Co-op was insolvent. We shall therefore affirm the verdict of the jury under the Arkansas Securities Act in all particulars.

F. The 10b-5 Claims Against Arthur Young

Arthur Young argues that as a matter of law, and on theevidence, the jury's verdict on the class's 10b-5 claim cannot stand. The class complained that Arthur Young failed to disclose certain information necessary to make its statements not misleading. Arthur Young counters that it owed no duty to the class, and that it can therefore not be held liable for failing to disclose anything to it. In support of its position, Arthur Young cites "insider" cases: *Chiarella v. United States*, 445 U.S. 222 (1980); *Dirks v. S.E.C.*, 463 U.S. 646 (1983); and *Laventhall v. General Dynamics Corp.*, 704 F.2d 407 (8th Cir.), *cert. denied*, 464 U.S. 846 (1983).

These cases control situations in which an investor, armed with material inside information, is liable to a seller for failing to disclose that information before buying stock on the market. In *Chiarella, supra,* the Supreme Court reversed and dismissed a criminal conviction against a print shop employee who had learned from documents that he was preparing that a merger was soon to take place. He bought shares in the target company and made a hefty profit. He did not disclose this information to sellers, and was indicted, as a consequence, for a fraudulent trading practice. The Supreme Court held that the mere fact that one trades on inside information, *simpliciter,* is not a sufficient basis for a criminal securities fraud prosecution; rather, the court held that there must be an independent duty at common law to disclose the information to the seller, and a breach of that duty, before it can be said that a party has violated the securities laws.

As we know, at common law, a buyer is not generally obliged to inform a seller that he is extending "too good a deal," Black, *Rescission and Cancellation* § 66 at 153 (1916), or to disclose to the seller inside information known only to the buyer which allows him substantially to profit from the seller's ignorant condition. *Laidlaw v. Organ,* 2 Wheat. 178, 4 L. Ed. 214 (1817); *Guaranty Safe Deposit Co. v. Liebold,* 208 Pa. 399, 56 A. 951 (1904). Even where the buyer was aware of "intrinsic" facts relating to the value of the property to be sold, of which the seller was ignorant, the law has denied relief. *Goodwin v. Agassiz,* 283 Mass. 358, 186 N.E. 659 (1933). There the court observed: "The law in its sanctions is not co-extensive with morality. It cannot undertake to put all parties to every contract on an equality as to knowledge, experience, skill, and

shrewdness. The action was one for rescission and rescission was denied." Of course, the rule is different where the buyer owes the seller a fiduciary duty to disclose all relevant information, or otherwise stands in a confidential relationship to him.

It was in reference to this old and settled body of law that the *Chiarella* court held that absent a fiduciary relationship, a buyer has no duty to communicate material inside information which he has gathered on his own. Similarly, in *Dirks v. S.E.C., supra,* the Court decided that an investment adviser who discovered a fraud by dint of his own efforts was not to be censured for advising his clients to sell their stock in the company. The Court emphasized that even though the adviser had gained his information from "insiders," they did not stand to gain from the disclosure. Furthermore, the tippers received no monetary or personal benefit for revealing the company's secrets, nor intended to make a gift of corporate assets to the adviser by informing him of circumstances corroborating his suspicions of fraud. Since there was no "insider liability" in such a context, the Court found that there could be no derivative liability on the part of Dirks for communicating his knowledge.

A relationship of trust and confidence may in certain cases be said to exist between a corporation and its shareholders. In such cases, courts have granted sellers remedies when the corporation, or its tippee, exploited "inside" information to derive an unfair advantage in a purchase. *Laventhall v. General Dynamics, supra,* held only that a corporation owed no duty to inform the holder of an *option* to buy the corporation's stock that it intended to declare a healthy dividend and split its stock. The court

decided that the fiduciary duties running from a corporation to its shareholders do not run to option holders, since the corporation's business is not run for such persons' benefit.

We do not believe that these cases control the issue before us. We do not think that the jury imposed liability on Arthur Young because of a supposed fiduciary *status*, but because of its affirmative acts. In this connection, language from the cited cases indirectly supports the plaintiffs' contentions. In *Dirks v. S.E.C., supra,* for example, the Court speaks not only of a breach of a fiduciary duty to speak, but breach of *any* "common law" duty. *Id.* at 653. At common law, in the absence of a fiduciary duty, a seller ordinarily can make as hard a bargain as he wishes, and incurs no liability for failing to enlighten the vendor. The case is otherwise where the buyer *knows* that the seller is laboring under a mistake. Williston, *Contracts* § 1548 n.47 and § 1557 n.89 (1920). In such cases, the common law may impose liability for failure to disclose the advantage. This doctrine is implicit even in hornbook cases denying relief to defrauded sellers. *Wood v. Boynton,* 64 Wis. 265, 25 N.W. 42 (1885) (no evidence jeweler *knew* the stone to be a diamond rather than a topaz; rescission denied). Mistake, in such contexts, is deemed to be something other than a lack of full information, else the exception would swallow the rule.

If, therefore, the common law imposes a duty on Arthur Young not to broadcast statements misleading because incomplete, then liability can be found under section 10b-5 even though no fiduciary relationship exists between Arthur Young and the class. There can be no question but that once a party chooses to speak, even

though he has no duty to do so, he assumes the duty not to speak fraudulently. Prosser & Keeton, *Law of Torts,* § 106 at 736-37 (5th ed. 1984), says:

> The representation which will serve as a basis for an action of deceit . . . usually consists of oral or written words. . . .
>
> The significance to be assigned to such words or conduct will be determined according to the effect they would produce . . . upon the ordinary mind. Ambiguous statements, which are reasonably capable of both a true and a false meaning, will amount to a misrepresentation if the false meaning is accepted, and is intended. . . . Likewise, misrepresentations may be found in statements which are literally true, but which create a false impression in the mind of the hearer, as is sometimes the case where a complicated financial statement is issued by a seller of securities. . . .
>
> In addition to such representations . . . deceit . . . may be based on an active concealment of the truth. Any words . . . which create a false impression covering up the truth, or which remove an opportunity that might otherwise have led to the discovery of a material fact . . . even a false denial of knowledge by one in possession of the facts – are classed as misrepresentation, no less than a verbal assurance that the fact is not true.

The common law forbids one to broadcast fraudulent information, or information subject to a "mental reservation" on the part of the speaker. In this case, the jury could believe that Arthur Young knew that the Co-op was insolvent "on the books." The auditors declared a false

value for the Co-op's assets, having an unexpressed "mental reservation" that the statement was "true" by virtue of a series of tenuous assumptions concluding in a finding that the Co-op always owned the gasohol plant, and could therefore carry it as a fixed asset at cost, rather than at value, with the balance accounted to "good will." APB 16.

The absence of a fiduciary relationship between Arthur Young and the class is simply a straw man. Arthur Young chose to speak, and the jury found that Arthur Young spoke falsely. Under Rule 10b-5, when a party undertakes to disclose anything, it has the duty to speak the full truth. *Cf. First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1317 (5th Cir. 1977), *cert. denied*, 435 U.S. 952 (1978). That duty derives from common law, irrespective of relationship. *Restatement (Second) of Torts* § 551(2)(b) comment g (1976).

Arthur Young also claims that regardless whether it spoke falsely or not, the class cannot recover because there was no evidence that any member of the class *relied* on any representation made by the auditors and partners. The plaintiffs answer this contention by claiming that reliance is presumed in cases of nondisclosure, citing *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972). (*See also Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384-85 (1970), a Rule 14a-9 case.)

We have had prior occasion to express our doubt concerning whether Arthur Young was guilty of a misrepresentation, or of an omission. (Summary Judgment Opinion, Oct. 15, 1986, at 104). It appears that where one fraudulently misstates a fact, a buyer must rely on the

truth of his statement, in the absence of which his action may not proceed. If the declarant *omits* to state a fact, there can, of course, be no reliance on an omission, and the buyer is accorded a rebuttable presumption of reliance, providing that the omission is sufficiently material to influence the reasonably prudent investor. Our concern was that at a very basic level, every "lie" omits to state the truth, and by using a sufficiently lively imagination, a plaintiff can shift the burden on an important element of the common law of deceit by so characterizing a statement made by a defendant. Rule 10b-5 would be therefore transformed into a scheme of "investment insurance."

This court is troubled by the conflict in our circuit between *Vervaecke v. Chiles, Heider & Co.*, 578 F.2d 713 (8th Cir. 1978), which reads *Affiliated Ute, supra,* narrowly, and the recent cases of *Barnes v. Resource Royalties, Inc.*, 795 F.2d 1359 (8th Cir. 1986), and *Harris v. Union Electric Co.*, 787 F.2d 355 (8th Cir. 1986), which read it broadly. *Vervaecke, supra,* set forth a workable rule which declared that where a defendant actually made a statement, such a statement must be found to have induced reliance. Under the *Vervaecke* rule, class members would presumably be required to assert that they depended on the precise valuation given the Co-op's assets. That is the chief defect of *Vervaecke:* it appears to require specific reliance in contexts where motivations are complex. Unfortunately, the report in *Vervaecke* failed ever to disclose what it is that the defendants were alleged to have said, or to have omitted. It is impossible to determine whether the statements were even material. It is therefore difficult to apply *Vervaecke* by analogy.

On the other hand, *Barnes v. Resource Royalties, Inc.*, and *Harris v. Union Electric Co., supra*, appear to presume reliance even where the plaintiff has pleaded specific reliance, and given evidence on the point. The references to "presumed reliance" appear to be merely gratuitous. For example, in *Barnes* the plaintiff complained that he had been fraudulently induced to buy stock in Resource Royalties, Inc., because he understood that the company was going to develop new products. Somewhat later he learned (a) that the stock had not been sold by Resource Royalties, Inc., but by a party named McPherson, (b) consequently, none of his money was received by Resource Royalties, Inc., and (c) the company was not developing any new products. The trial court found that the buyer "repeatedly testified that he did not care who sold the securities or even what corporate entity he was investing in; plaintiff simply wanted 'a piece of the action.'" *Barnes v. Resource Royalties, Inc.*, 610 F. Supp. 499, 504 (E.D. Mo. 1985) (decision below). If the buyer did not care from whom he bought the Resource Royalties stock, then it scarcely could matter that his money did not end up in the corporate treasury. After all, blue chip stocks are bought and sold in the millions of shares every day, and no one supposes that after the initial issue money rolls into the treasury of the issuer from subsequent sales by traders. Nevertheless, the court of appeals reversed the trial court in *Barnes v. Resource Royalties*, 795 F.2d at 1367, saying:

> Although the district court discussed some rebuttable [sic] evidence, its discussion only addressed the misrepresentation that the McPhersons were sellers. That evidence did not address the alleged failure to disclose that the

> money Barnes paid for his Resource Royalties shares was never invested in Resource Royalties and never used to develop new products.

Because of this omission, the court decided that "The failure to disclose that the money was not invested in these corporations, and therefore not used to develop new products, is sufficient to raise the presumption of reliance." *Id.*

In *Harris v. Union Electric Co., supra,* the plaintiffs argued that the prospectus was misleading. The purchasers of the bonds thought that they were buying bonds with a ten-year protection from a call by the company. Union Electric argued that the bonds themselves *and* the prospectus revealed that it would call bonds before ten years if the funds to do so came from the Improvement and Maintenance Fund. The court of appeals admitted that both parties' interpretation of the prospectus was "plausible." *Id.* at 364. It should have been relatively easy, under *Vervaecke,* for bond buyers to stand, yea or nay, on whether they relied on the particular interpretation favorable to them in deciding whether to buy the bonds. They did not have to do so, however, since both the trial and the appellate court placed the onus on the seller to declare his intention. The court said:

> Reliance is established when the plaintiff shows that he was induced to act differently than he otherwise would have in making his investment decision. *St. Louis Union Trust Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 562 F.2d at 1048 (1977). Because the plaintiffs' complaint consists primarily of allegations of a failure to adequately disclose the call-protection rights,

reliance in this case can be inferred from materiality.

Both *Barnes* and *Harris*, then, significantly cut into *Vervaecke's* limitation on *Affiliated Ute Citizens v. United States, supra. Vervaecke* declared that *Affiliated Ute* did not apply in cases where statements were "actually made" because "where the securities fraud at issue closely resembles the tort of deceit, the plaintiff encounters no special difficulty in attempting to demonstrate reliance. The lack of any barrier to proof permits the private action adequately to serve its dual purposes. . . . " *Vervaecke v. Chiles, Heider & Co., Inc.*, 578 F.2d at 717, citing Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 589 (1975).

We strongly suspect that *Barnes* and *Harris* implicitly overrule *Vervaecke*, and permit the plaintiff to characterize the case as he pleases. As we have previously said, every affirmative misrepresentation contains within it the seeds of omission. Other circuits recognize that the labels themselves are of little help. *Wilson v. Comtech Telecommunications Corp.*, 648 F.2d 88, 93 (2d Cir. 1981). The distinction between an active "misrepresentation" and an "omission" is recognized as fuzzy at best. *Little v. First California Co.*, 532 F.2d 1302, 1304 n.4 (9th Cir. 1976). Our problem is compounded by the fact that neither *Barnes* nor *Harris* even mentioned *Vervaecke* and its applicability to the problem even though all three cases seemed to turn on it.

A deep reading of the cases convinces this court that it is an utterly feckless exercise to apply *Vervaecke* so long as any plausible case can be made for the following proposition: that if the plaintiff had known of a given

fact, his decision would have been different. If that proposition is read into the cases, the holdings can be harmonized. At that point, the burden-shifting mechanism of presumed reliance makes more sense. First, in an individual case, requiring one to prove a speculative negative (I-would-not-have-bought-if-I-had-known) inevitably leads to *pro forma* recitations, self-serving, tedious, and drawn-out, addressed to possibilities in the context of a decision made in an environment where motivation is complex and difficult to determine. *Affiliated Ute Citizens v. United States,* and, to an extent, *Mills v. Electric Auto-Lite Co., supra,* were both concerned that such evidence be considered unnecessary.

In a class action, the rationale applies *a fortiori.* Once the emphasis is placed on the state of mind of the many plaintiffs (reliance) instead of the few defendants (*scienter*) the whole rationale for class actions in securities cases disappears because the *common* questions of fact and law will cease to preponderate. Fed. R. Civ. P. 23a(2), b(3). Such an emphasis, furthermore, threatens to defeat valid claims. Implicit in *Affiliated Ute* is a rejection of the burden because it leads to underinclusive recoveries and threatens enforcement of the securities laws. Note, *Reliance Requirement in Private Actions Under SEC Rule 10b-5, supra,* at 590-91.

In any and all events, Arthur Young & Co. invited the omissions characterization, and is in the least appealing position to invoke the *Vervaecke* protections. Arthur Young faced an action by the trustee for negligence, and one by the class for fraud. Arthur Young stood to defeat both actions by showing that it had faithfully discharged its engagement by complying with Generally Accepted

Accounting Principles and Generally Accepted Auditing Standards (GAAPs and GAASs) consistently applied. In its opening statement, Arthur Young defended its valuation of the gasohol plant by invoking "the economic realities test." It suggested that the passage of title to the plant was shrouded in confusion, and that since all moneys for its development originated from the Co-op, inconsistent data concerning title could be ignored and "the economic realities" invoked to declare the Co-op the owner of the plant *ab initio*; therefore justifying the inflated valuation of the plant carried on the books; therefore permitting the co-operative to wear a cheap rouge of fiscal salubrity to mask a facial insolvency. Such a method of analysis is "exceptional," to say the least. It comes with small grace from one who defends his performance on the basis of an exceptional doctrine or procedure, to challenge the right of a class of investors to shift the burden of proving reliance to him because he admittedly *omitted* to tell *them* that his figures were "valid" only under a series of tenuous assumptions and by virtue of an exceptional procedure.

G. <u>The Rescissionary Remedy</u>

In determining whether rescission is a proper remedy in this case it would be well to keep in mind that we are dealing with debt securities – demand notes – rather than equity securities such as stocks. The rescissionary remedy which we contemplate will transfer notes from the class to Arthur Young & Co., who may then present them for payment to the trustee. Arthur Young will get the full *pro tanto* benefit of the class's settlement and allocation. In addition, Arthur Young will incidentally benefit from the

trustee's settlements and recoveries. In presenting the notes to the trustee, Arthur Young will participate in an estate which has been augmented by at least $3.4 million, and possibly more, once the estate takes possession of the allocated settlements and the Ball and Mourton judgment. Arthur Young will participate in the estate not as an equity shareholder would – behind the class of general creditors – but as a general creditor itself. One very substantial difficulty with the "out of pocket" measure of damages urged by Arthur Young & Co. is that to determine any individual recovery, one would have to construct *formulae* by which one could compute at any given instant the liquidation value of the Co-op when it issued the note. Since current ratio would be an important element in calculating the liquidation value of the Co-op, and since each note, withdrawal, and addition of interest would alter the current ratio, one can easily see that the evidentiary problem would be enormous. One should not lightly impose staggering computational burdens on an investor class, tying a court and jury up for weeks with mathematical *arcana* and multivariate regressions, on an issue for which the defense has chosen to offer no proof, theory of mitigation, or alternate solution. This is particularly the case where a procedure exists which not only greatly simplifies the jury's fact-finding task, but puts plaintiffs in the position they would have occupied if everyone had acted properly. *Speed v. Transamerica Corp.*, 135 F. Supp. 176 (D. Del. 1955).

Using this latter criterion, one concludes that, more than probably, if Arthur Young had "acted properly" and had issued an adverse opinion in 1982, the estate would have saved $2.0 million in further losses. Arthur Young

was found to have been half responsible for those losses, but of course not being preponderantly liable, was not answerable at all to the trustee in his suit. We do not quarrel with the law. We note, however, that one of the objections to the rescissionary remedy is that it permits one to recover for losses not exclusively or even partly caused by the fraud, but by market forces and conditions occurring after the sale. *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1342 (9th Cir. 1976). In this particular case, Arthur Young was found by the jury to have been half responsible for the Co-op's losses after April 22, 1982. Under an "out of pocket" measure of recovery, the class would fail to recover for subsequent declines, fully half of which were caused by Arthur Young. For the balance, they would have to apply to an estate which was depleted not in small part by Arthur Young's actions. As between a victim and the perpetrator, on whom should the loss fall? While there are good and substantial reasons why Arthur Young should be protected from damages arising from the trustee's suit, that rationale does not extend to parties, wholly innocent of blame, who were intentionally (or recklessly) misled to their ruin.

Finally, it bears remarking that the securities laws are bottomed in tort, not in contract. The conceptual difficulty to which Arthur Young alludes concerning the rescissionary remedy is one which proceeds from contract: *i.e.*, how can one "restore" that which he never received? The forms of action are dead, saith Maitland, but they truly rule us from the grave if they disable a court and jury from administering relief on a rational and efficient basis because "contract doctrine" holds that "specific restitution" cannot be ordered of one who has

not directly received property from the plaintiff, or who is not otherwise in privity with him.

Thus, in *Rolf v. Blythe, Eastman, Dillon & Co., Inc., supra*, a BEDCO employee was held guilty of aiding and abetting the 10b-5 violation (largely because he recklessly failed to stop a fraud) of an independent investment advisor who churned and ravaged an investment account. Rescission was ordered against the BEDCO broker, and against BEDCO itself, even though the employee did not execute the transaction, recommend the security, or reassure the plaintiff with respect to the security. *Id.* at 49. Rescission was ordered, not because the particular defendant had possession of plaintiff's property, but because that measure of damages most nearly made the victim whole.

Loss, *Fundamentals of Securities Regulation* § 1183 (1983), notes:

> There is nothing basically incongruous about forcing a broker for either seller or buyer to assume ownership of securities for the first time. When rescission is based on contract theory – mistake or breach of contract – only the party to the contract is liable. But when it is based on fraud, privity is not essential. "To avoid unjust enrichment, general equitable principles indicate the preferability of the purchaser pursuing first the seller, rather than his partner in the fraud. However, as between the innocent purchaser and the wrongdoer who, though not a privy to the fraudulent contract, nonetheless induced the victim to make the purchase, equity requires the wrongdoer to restore the victim to

> the status quo." *Gordon v. Burr*, 506 F.2d 1080, 1085 (2d Cir. 1974).

(concerning section 12 liability).

The principle isolated by Loss is fully applicable here in a 10b-5 case. The goal of the securities laws is to *restore* the defrauded party to his *status quo ante* the purchase. The laws do not exist to give him a windfall. They do not indemnify his "expectations," or punish wrongdoers. Securities Exchange Act of 1934 § 28(a). Where a rescissionary remedy, as here, is plainly more appropriate in consideration of the plaintiff's loss, as well as in view of all the other facts and circumstances of the case, including the seriousness of the defendant's conduct, we are convinced that it should be chosen as the best and fairest method of restitution.

In summary, therefore, we find no merit in Arthur Young's contentions that the 10b-5 verdict should be set aside for lack of evidence or legal substantiation. Arthur Young has argued that the jury has unprecedentedly assigned liability to a secondary party for a failure to discover a fraud, and has argued that it owed no such duty to the broad class of investors. This case is, in a sense, unprecedented. On the charge under the Arkansas Securities Act, the jury found that Arthur Young essentially manufactured the misleading statements by means of which the demand notes were sold. We have to agree that this indeed is singular behavior. That circumstance, however, should not be one from which Arthur Young should take heart; rather it is a circumstance from which

it should take stock. The evidence fully justified the verdict against Arthur Young, and the "rescissionary" remedy we have applied. Furthermore, the circumstances of the case are such that prejudgment interest is appropriate, especially given the essentially liquidated nature of the demand. Upon entry of the judgment under 10b-5, plaintiffs may apply for attorneys' fees conformably with local rules (they will do so in any event as a result of the verdict under the state securities law) and the court will determine the propriety of any award under 10b-5, as well as the amount under either verdict.

/s/ H. Franklin Waters
United States
District Judge

Date: Feb. 5, 1987.

APPENDIX F

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as
Trustee of the Farmer's Co-Op
of Arkansas & Oklahoma, Inc.;
BOB REVES; FRANCES GRAHAM;
ROBERT H. GIBBS, individually;
ROBERT H. GIBBS, as natural
guardian of his minor children;
THOMAS A. GIBBS and ROBERT H.
GIBBS, JR.; and ROBERT H.
GIBBS, JR., as Trustee of the Muskogee
Internal Medicine Group Profit
Sharing Funds PLAINTIFFS

v. Consolidated Cases No. 85-2044,
85-2096
85-2155
85-2259

JACK E. WHITE, ET AL. DEFENDANTS

JUDGMENT ORDER

[Filed February 5 1987]

This cause having been tried before this court and the jury having rendered its verdict, the court orders that judgment be entered as follows:

Definitions

1. Plaintiff *Thomas E. Robertson, Jr.,* ("Robertson") is the Trustee in Bankruptcy of the Farmer's Co-Op of Arkansas and Oklahoma, Inc. ("Co-Op").

2. The plaintiff *Class* is that group of individuals who purchased demand notes from the Co-Op between the dates of April 22,-1982, and February 23, 1984. Bob Reves, Frances Graham and Robert H. Gibbs are the Class representatives.

3. Defendant *Ball, Mourton & Adams* is a law partnership whose partners include E.J. Ball, Kenneth R. Mourton and Stephen E. Adams. It refers to and includes its predecessor firm, Ball & Mourton. A judgment against the partners and the partnership is effective against Stephen E. Adams only to the extent of his interest.

4. Defendant *Arthur Young* means Arthur Young & Company, four of whose partners at the times in question were defendants Harry C. Erwin, Billy Joe Cabaniss, Jr., Joseph F. Drozal, Jr., and Charles M. Hanson.

5. *Third party defendants* are Hall Brewer, Waldo Price, Truman O. Boatright, J.O. McClure, Hugh Winfrey, Jr., M.V. Creech, Charles Bane, E.H. Pritchett, Jr., Robert Plunkett, Ralph McClure, Jimmy Don Gooch, Jerry Metzger, W.J. Rimmer, Don Sebo, Joe Wayne Harris, James Willis, Dan Ray Core, Harold Davis, Jay Freeman, Jay Neal, Jr., George Wagnon, Raymond (Jack) Clark and Eddie Joe Smith.

JUDGMENT

Judgment shall be entered as follows:

1. As to Count III, alleging violations of the Arkansas and federal securities laws, a new trial is granted defendants Ball, Mourton & Adams, and E.J. Ball and Kenneth R. Mourton, unless the Trustee accepts,

within ten (10) days of the filing on this judgment, a remittitur on the verdict found by the jury in the sum of $982,000. If the Trustee accepts the remittitur, then judgment shall enter in the sum of $1,750,000 under both state and federal claims. The verdict and judgment under the state securities law shall bear prejudgment interest at the rate of six percent (6%), but no interest shall be collected on the federal law claim. The matter of fees and costs shall be taken up on motion after the filing of this judgment, in accordance with the opinion filed contemporaneously herewith. As a credit against the judgment amount, the defendants Ball, Mourton & Adams, and Ball and Mourton, shall be allowed the sum of either $2,692,000 on the state law claim or $1,030,656 on the federal law claim, conditional on the approval of settlements with the Trustee and the Class, now set for March 30-31, 1987. The court shall later set a schedule for plaintiffs to file a bill of costs and a petition to establish the amount of prejudgment interest and fees due. The Trustee shall be allowed the larger net recovery under this Count, after allowance of credits and establishment of interest, fees and costs.

2. As to Count VI, Arthur Young is ordered to pay to the Class $6,121,652.94, plus prejudgment interest, fees and costs, under both state and federal claims, subject to a credit in the amount of $5,600,000, conditional on settlements with the Class being approved. The judgment shall bear prejudgment interest and carry an award of fees under the state act, and prejudgment interest under the federal securities laws claims. Questions relating to the eligibility for fees under the federal claim, and the amount of any fees, shall be later determined. The court shall set a schedule for plaintiffs to file a bill of costs and

a petition to establish the amount of prejudgment interest and fees due. The Class shall be allowed the larger net recovery under this Count, after allowing credits and determining fees, interest and costs.

3. As to Count VII, judgment is entered for the Trustee against Ball, Mourton & Adams, and Ball and Mourton, in the amount of $51,980, plus costs, which shall be reduced in the sum of any unused credits given in paragraph 1.

4. Judgment is entered for defendants and against plaintiffs on Counts I, II, IV and XI.

5. Judgment is entered for third party defendants on all third party claims.

6. Judgment is entered for the plaintiffs on all counterclaims.

7. Pursuant to Rule 54b, the court finds that there is no just reason to delay enforcement of or appeal of this judgment.

IT IS SO ORDERED.

/s/ H. Franklin Waters
United States District Judge

Date: Feb. 5, 1987 .

APPENDIX G

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as Trustee of the Farmer's Co-Op of Arkansas & Oklahoma, Inc.; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds — PLAINTIFFS

v. — Consolidated Cases No. 85-2044, 85-2096, 85-2155, 85-2259

JACK E. WHITE, ET AL. — DEFENDANTS

AMENDED JUDGMENT ORDER

[Filed April 27, 1987]

This cause having been tried before this court and the jury having rendered its verdict, the court orders that judgment be entered as follows:

Definitions

1. Plaintiff *Thomas E. Robertson, Jr.,* ("Robertson") is the Trustee in Bankruptcy of the Farmer's Co-Op of Arkansas and Oklahoma, Inc. ("Co-Op").

2. The plaintiff *Class* is that group of individuals who purchased demand notes from the Co-Op between the dates of April 22, 1982, and February 23, 1984. Bob Reves, Frances Graham and Robert H. Gibbs are the Class representatives.

3. Defendant *Ball, Mourton & Adams* is a law partnership whose partners include E.J. Ball, Kenneth R. Mourton and Stephen E. Adams. It refers to and includes its predecessor firm, Ball & Mourton. A judgment against the partners and the partnership is effective against Stephen E. Adams only to the extent of his interest.

4. Defendant *Arthur Young* means Arthur Young & Company, four of whose partners at the times in question were defendants Harry C. Erwin, Billy Joe Cabaniss, Jr., Joseph F. Drozal, Jr., and Charles M. Hanson.

5. *Third party defendants* are Hall Brewer, Waldo Price, Truman O. Boatright, J.O. McClure, Hugh Winfrey, Jr., M.V. Creech, Charles Bane, E.H. Pritchett, Jr., Robert Plunkett, Ralph McClure, Jimmy Don Gooch, Jerry Metzger, W.J. Rimmer, Don Sebo, Joe Wayne Harris, James Willis, Dan Ray Core, Harold Davis, Jay Freeman, Jay Neal, Jr., George Wagnon, Raymond (Jack) Clark and Eddie Joe Smith.

JUDGMENT

Judgment shall be entered as follows:

1. As to Count III, alleging violations of the Arkansas and federal securities laws, a new trial is granted defendants Ball, Mourton & Adams, and E.J. Ball and Kenneth R. Mourton, unless the Trustee accepts,

within ten (10) days of the filing on this judgment, a remittitur on the verdict found by the jury in the sum of $982,000. If the Trustee accepts the remittitur, then judgment shall enter in the sum of $1,750,000 under both state and federal claims. The verdict and judgment under the state securities law shall bear prejudgment interest at the rate of six percent (6%), but no interest shall be collected on the federal law claim. The matter of fees and costs shall be taken up on motion after the filing of this judgment, in accordance with the opinion filed contemporaneously herewith. As a credit against the judgment amount, the defendants Ball, Mourton & Adams, and Ball and Mourton, shall be allowed the sum of either $2,692,000 on the state law claim or $1,030,656 on the federal law claim, conditional on the approval of settlements with the Trustee and the Class, now set for March 30-31, 1987. The court shall later set a schedule for plaintiffs to file a bill of costs and a petition to establish the amount of prejudgment interest and fees due. The Trustee shall be allowed the larger net recovery under this Count, after allowance of credits and establishment of interest, fees and costs.

2. As to Count VI, Arthur Young is ordered to pay to the Class $6,121,652.94, plus prejudgment interest, attorney fees (only on the state securities claims) and costs, under both state and federal claims, subject to a credit in the amount of $5,744,780, conditional on settlements with the Class being approved. The judgment shall bear prejudgment interest and carry an award of fees under the state act, and prejudgment interest under the federal securities laws claims. Questions relating to the eligibility for fees under the federal claim, and the amount of any fees, shall be later determined. The court

shall set a schedule for plaintiffs to file a bill of costs and a petition to establish the amount of prejudgment interest and fees due. The Class shall be allowed the larger net recovery under this Count, after allowing credits and determining fees, interest and costs.

3. As to Count VII, judgment is entered for the Trustee against Ball, Mourton & Adams, and Ball and Mourton, in the amount of $51,980, plus costs, which shall be reduced in the sum of any unused credits given in paragraph 1.

4. Judgment is entered for defendants and against plaintiffs on Counts I, II, IV and XI.

5. Judgment is entered for third party defendants on all third party claims.

6. Judgment is entered for the plaintiffs on all counterclaims.

7. Pursuant to Rule 54b, the court finds that there is no just reason to delay enforcement of or appeal of this judgment.

IT IS SO ORDERED.

/s/ H. Franklin Waters
United States District Judge

Date: Apr. 23, 1987 .

APPENDIX H

IN THE UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF ARKANSAS
FORT SMITH DIVISION

THOMAS E. ROBERTSON, JR., as Trustee of the Farmer's Co-Op of Arkansas & Oklahoma, Inc.; BOB REVES; FRANCES GRAHAM; ROBERT H. GIBBS, individually; ROBERT H. GIBBS, as natural guardian of his minor children, THOMAS A. GIBBS and ROBERT H. GIBBS, JR.; and ROBERT H. GIBBS, as Trustee of the Muskogee Internal Medicine Group Profit Sharing Funds — PLAINTIFFS

v. Consolidated Cases No. 85-2044, 85-2096, 85-2155, 85-2259

JACK E. WHITE, ET AL. — DEFENDANTS

ORDER

[Filed April 27, 1987]

On this 23rd day of April, 1987, upon consideration of the post-judgment motions filed in the above captioned matter, the court finds as follows:

1. The motion of Arthur Young in support of its motion for judgment notwithstanding the verdict or, in the alternative, for a rehearing with respect to the issue of damages is denied.

2. The motion of Arthur Young to amend the judgment and to correct a clerical mistake is partially granted in that the judgment will be amended pursuant to Federal Rule of Civil Procedure 60(b) to correct a computational error in the calculation of the settlement credits and to reflect that attorneys' fees are not available under the federal securities law claims.

3. The plaintiffs' motion for amendment of judgment or, in the alternative, for reconsideration is denied.

IT IS SO ORDERED.

/s/ H. Franklin Waters
United States District Judge

APPENDIX I

United States Court of Appeals

FOR THE EIGHTH CIRCUIT

No. 87-1726/1727/1803/2533/88-1014WA

Arthur Young & Company,	*	Appeal from the United
Appellant,	*	States District Court for
	*	the Western District of
vs.	*	Arkansas
	*	
Bob Reves, et al.,	*	
Appellees.	*	

Appellant's petition for rehearing has been considered by the Court and is denied.

August 29, 1991

Order Entered at the Direction of the Court:

/s/ Michael E. Gens

Clerk, U.S. Court of Appeals, Eighth Circuit

APPENDIX J

STATUTORY PROVISIONS INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j, provides in pertinent part:

> Sec. 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or use of the mails . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 106 of the Arkansas Securities Act, Ark. Stat. Ann. § 23-42-106 provides in pertinent part:

> (a)(1) Any person who commits the following acts is liable to the person buying the security from him, who may sue either at law or in equity to recover the consideration paid for the security, together with interest at six percent (6%) per year from the date of payment, costs, and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security and any income received on it, or for damages if he no longer owns the security:
>
> (A) Offers or sells a security in violation of §§ 23-42-301, 23-42-212(b), or

23-42-501 or of any rule or order under § 23-42-502 which requires the affirmative approval of sales literature before it is used, or in violation of any condition imposed under §§ 23-42-403(d), 23-42-404(g), or 23-42-404(i); or

(B) Offers or sells a security by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of circumstances under which they are made, not misleading, the buyer not knowing of the untruth or omission, and who does not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission;

(2) Damages are the amount that would be recoverable upon a tender less the value of the security when the buyer disposed of it and interest at six percent (6%) per year from the date of disposition.

(c) Every person who controls a seller liable under subsection (a) of this section or a purchaser liable under subsection (b) of this section; every partner, officer, or director of such a seller or purchaser; every person occupying a similar status or performing a similar function; every employee of such a seller or purchaser who materially aids in the sale; and every broker-dealer or agent who materially aids in the sale are also liable jointly and severally with, and to the same extent as, the seller or purchaser, unless the nonseller or nonpurchaser who is so liable sustains the burden of proof that he did not know, and in the exercise of

reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist. There is contribution as in cases of contract among the several persons so liable.

Supreme Court, U.S.
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No. 91-877

IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1991

ERNST & YOUNG,

Petitioner,

v.

BOB REVES, ROBERT H. GIBBS, and FRANCES GRAHAM, As Representatives of a Class of Note Holders,

Respondents.

BRIEF OF THE CLASS IN OPPOSITION TO ERNST & YOUNG'S PETITION FOR A WRIT OF CERTIORARI

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STATEMENT OF THE CASE

This Statement of the Case will supplement the Eighth Circuit's detailed factual analysis (EY Pet. App. at 6a-27a[1]) and address the most important aspects of Arthur Young's fraud. It will explain the facts that led the jury in this case to conclude that Arthur Young originated the securities fraud here by straying far from its role as auditor and falsely portraying a farmer's cooperative as solvent to investors.

The Co-op

The Farmer's Cooperative of Arkansas and Oklahoma, Inc. (the "Co-op"), an organization of local farmers, raised almost all of its operating funds by

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[1] This response will cite to Ernst & Young's Petition as "EY Pet." and the Appendix to that petition as "EY Pet. App.".

selling promissory notes to its 23,000 members, all of whom were solicited regularly, and some other local persons. These notes were uncollateralized, uninsured, and payable on demand. The Co-op marketed its notes as an "Investment Program" and told investors that "YOUR CO-OP has more than $11,000,000 in assets to stand behind your investments."

The note program was started in 1959 by Jack White, who served as the Co-op's general manager for many years. The Co-op sold many millions of dollars of demand notes; at the time the Co-op declared bankruptcy in February 1984, over 1600 persons held notes they had purchased for nearly $10 million.

<u>The Gasohol Plant</u>

The Co-op's gasohol plant lies at the center of Arthur Young's fraudulent scheme. Jack White -- before he was jailed

for tax fraud involving self-dealing transactions with the Co-op -- had owned a gasohol plant. When it became apparent that the plant was a white elephant, he sold it to the Co-op by means of a "friendly" lawsuit. As a result of White's self-dealing, the Co-op was rendered insolvent.

Arthur Young's 1981 Audit

A partner in the accounting firm Russell Brown & Co. (which later merged into Arthur Young) testified on Jack White's behalf at his criminal trial. In 1981, while White's conviction was on appeal, White hired Arthur Young to prepare the Co-op's 1981 audit.

Prior to Arthur Young's engagement, the gasohol plant had not been included on the Co-op's financial statements. Arthur Young soon realized that properly-prepared financial statements

would disclose that the Co-op was insolvent and that White had taken advantage of the Co-op. In that event, as Arthur Young also recognized, there would be a run on the Co-op: many noteholders would seek to redeem their notes, no new ones would be sold, and the Co-op would become bankrupt. If that happened, Arthur Young would lose its biggest local account, and Arthur Young's prior testimony on White's behalf would appear suspect.

After consulting with White, Arthur Young began to construct a series of fictions (contrary to accepted accounting standards) that permitted it to create financial statements concealing the Co-op's insolvency. The key fiction was that the Co-op always owned the gasohol plant and that Jack White never did. As the district court stated:

> [T]he jury found on substantial evidence that Arthur Young originated the fraud, and we may say that it was rather obvious that Arthur Young "struggled hard" to make the Co-op appear solvent, against all available data and any reasonable characterization of it.

Arthur Young never revealed these fictions to the Co-op's Board of Directors ("Board"), the Co-op's financial officer, or to anyone else.

After the Board adopted Arthur Young's false financial statements for 1981, the Co-op continued to sell demand notes to its members and others. Arthur Young knew that the Co-op offered the notes for sale every month in its widely-circulated newsletter, representing that the Co-op had sufficient assets to enable it to redeem the notes on demand.

The Co-op's 1982 Annual Meeting

Prior to the 1982 annual meeting of its members, the Co-op prepared a

summary statement of its financial condition by condensing the false statements Arthur Young had prepared. Those condensed statements were reviewed and approved by Arthur Young and then included in the Co-op's Notice Of Annual Meeting. Like the full statements, the condensed ones concealed the Co-op's insolvency. Arthur Young attended the annual meeting and used the condensed statements to report on the Co-op's financial condition. Arthur Young did not tell the attendees (who asked many questions of Arthur Young about the gasohol plant and the condensed financial statements) that the Co-op was insolvent. Nor did Arthur Young advise them that it believed the condensed statements to be misleading. The press, which reported on the meeting to members and to others in the local community, was unable (due to Arthur

Young's fraud) to accurately report on the Co-op's financial condition.

Arthur Young's 1982 Audit

After the 1982 annual meeting, Arthur Young continued its pattern of deception. It maintained an office at the Co-op, working there regularly. Arthur Young observed that the Co-op's financial condition had grown even weaker. Nevertheless, in the early 1983, Arthur Young completed its preparation of a new set of financial statements. These, too, assumed that White never owned the gasohol plant and thus concealed the Co-op's insolvency.

The Co-op's 1983 Annual Meeting

As in the prior year, Arthur Young reviewed and approved the Co-op's false condensed statements, which accompanied the Notice of Annual Meeting. Arthur Young appeared at the 1983 annual meeting to

report on the Co-op's financial condition. Arthur Young again failed to disclose to the members in attendance that both the full and the condensed statements concealed the Co-op's insolvency.

Arthur Young And The Class

Throughout this period, the Co-op continued to sell demand notes as investments to its members and other local persons. No purchasers, members, or directors were informed by Arthur Young that the Co-op was insolvent. On numerous occasions, Arthur Young should have told the truth -- in its full financial statements, during its meetings with the Board, in the condensed statements, during its presentations at the annual meetings -- but it never did. As a result, between the date of Arthur Young's first false financial statement and the date of the Co-op's voluntary filing for bankruptcy,

Co-op members and others in the area purchased over $6 million of demand notes from an enterprise that Arthur Young knew to be insolvent.

These note purchasers are the members of the Class. The most basic common sense holds that none of them would have purchased a demand note had they known that Arthur Young had concluded that the Co-op was insolvent. They made their purchases only because Arthur Young consistently disseminated financial information, both directly and through the Co-op, that concealed the Co-op's insolvency (as well as numerous other facts that the courts below found material). Had Arthur Young ever told the truth, the news that the Co-op was insolvent would have spread quickly through the membership.

The Co-op's Bankruptcy

Arthur Young's fraud began to come apart after the Arkansas and federal governments looked into the Co-op's financial condition and asked Arthur Young to stand by the financial statements it had prepared. Arthur Young responded with a vague letter. When the Arkansas Securities Department began to press its view that the notes were securities, Arthur Young resigned. Within the next few months, as the Co-op's true financial picture began to emerge, many notes were redeemed and few were purchased. When the demand note balance fell below $9.5 million, Farmland (the major creditor and supplier of the Co-op) refused to extend any more trade credit to it. The Co-op then made a voluntary filing for bankruptcy. No demand notes were sold after that filing.

The Proceedings Below

In 1987, after a four-week trial, a jury found that Arthur Young had intentionally violated the anti-fraud provisions of both the Arkansas and federal securities laws by originating the fraud.[2] Thus, Arthur Young became liable to the Class under both federal and state law judgments (although the damages overlap).

Arthur Young appealed from the adverse judgments against it. One its many arguments was that the Co-op's demand notes were not securities under state or federal law. The Eighth Circuit accepted Arthur Young's view and reversed, without deciding

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[2] The Class also asserted a RICO claim against Arthur Young, predicated on Arthur Young's acts of securities fraud. The district court entered summary judgment against that claim, and the court of appeals affirmed. The RICO claim is the subject of the Class' separate petition for a writ of certiorari. (See infra note 3.)

any other issue. The Class, supported by the SEC and the Arkansas Securities Department, brought the securities issue before this Court. In Reves v. Ernst & Young, 494 U.S. 56 (1990), this Court rejected the Eighth Circuit's test for notes and held that the Co-op notes are securities.

On remand, the Eighth Circuit decided the many appellate issues in an opinion so comprehensive that it has a table of contents. The Court carefully considered each argument of the parties and (while remanding for a recalculation of damages) affirmed both the federal and state securities law judgments against Arthur Young.

SUMMARY OF ARGUMENT

Arthur Young presents no special or important reason why this Court should review the securities law rulings of the Eighth Circuit. There is no conflict among the circuits here; nor did the Eighth Circuit fail to follow state or Supreme Court precedent. Thus, there is no reason to disturb the securities law decisions of the jury, the district court, and the Eighth Circuit.

Moreover, while the factual issues on the securities claims are complex, the legal issues are not. First, the Eighth Circuit applied settled law in affirming the district court's ruling that the Class' Rule 10b-5 claim was entitled to a rebuttable presumption of reliance under the rule of Affiliated Ute. Arthur Young contends that the Eighth Circuit (as well as the district court) "seriously

misconstrued" the applicable precedent and thus applied it incorrectly to the particular facts of this case. (EY Pet. at 12.) This claim -- which in any event is mistaken -- is not a sufficient reason for this Court to grant the petition.

Second, Arthur Young asks this Court to take the extraordinary measure of reviewing the Eighth Circuit's interpretation of Arkansas law. Arthur Young does so because it violated both the federal and state securities laws, and thus a victory on the federal securities law judgment, by itself, would not erase Arthur Young's liability to the Class. There simply is no basis for Arthur Young's contention that the Eighth Circuit went awry; indeed, it is apparent from the opinion below that the Eighth Circuit carefully analyzed the many arguments

presented to it and reached rational and just decisions.[3]

I. THE EIGHTH CIRCUIT CORRECTLY APPLIED THE RULE OF AFFILIATED UTE.

A. The Eighth Circuit's Decision

Arthur Young disputes the Eighth Circuit's ruling on only one element of the Class' Rule 10b-5 claim -- reliance -- which the appellate court (and Arthur Young below) called "transaction causation." See also Harris v. Union Electric Co., 787 F.2d 355, 366 (8th Cir.), cert. denied, 479 U.S. 823 (1986). That element requires proof

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[3] The Class holds the same view even in the context of its own petition for a writ of certiorari. While the Eighth Circuit affirmed the summary judgment against the Class' RICO claim, it candidly explained that it was bound to follow the precedent of the court of appeals en banc "until the Supreme Court rejects our standard." (EY Pet. App. at 30a.)

that "the allegedly fraudulent acts caused the plaintiff to purchase the securities." (EY Pet. App. at 39a-40a.)[4]

The Eighth Circuit held that under Affiliated Ute and its progeny, the Class was entitled to a rebuttable presumption of transaction causation because (a) the claim was based primarily on Arthur Young's nondisclosures (rather than affirmative misrepresentations) and (b) Arthur Young

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[4] Transaction causation is the more appropriate term here. In this case and others in which the fraud consists primarily of omissions and nondisclosures, it is awkward to say that a plaintiff "relied" on those omissions and nondisclosures in buying securities. See Latigo Ventures v. Laventhol & Horwath, 876 F.2d 1322, 1326 (7th Cir. 1989). It makes more sense to say that omissions and nondisclosures "caused" a plaintiff to enter into an investment transaction, or put another way, a plaintiff who knew the omitted or nondisclosed information -- such as the Coop's insolvency -- would not have purchased the securities.

owed the Class a duty to tell the truth about the Co-op's financial health.

1. Nondisclosure

The Eighth Circuit, affirming the decision of the district court, ruled that the "facts and pleadings" demonstrated that the Class' claim was principally one of nondisclosure. The Eighth Circuit recognized that Arthur Young knew early on in this case that the Class intended to rely on a nondisclosure-based rebuttable presumption, and that it nevertheless made no effort to rebut that presumption (even though it had deposed numerous Class members). The Eighth Circuit concluded that "[f]or Arthur Young to argue now that it was entitled to judgment as a matter of law because the Class did not show transaction causation is a bold move indeed." (EY Pet. App. at 43a (footnote omitted).)

2. Duty To Disclose

As for the Arthur Young's duty to disclose, the court of appeals stated that whether this duty exists depends on the particular facts and circumstances of each case. The court then applied a seven-factor test to the facts here and concluded that Arthur Young owed the Class a duty to tell them about the fraud it originated and perpetuated.

The Eighth Circuit also dismissed Arthur Young's claim that it had no means to satisfy that duty as "preposterous":

> At the annual meetings Arthur Young could have said something, but simply chose not to. . . . Given the importance of the [many nondisclosures], the nature of the Co-op and the people who invested in it, the Co-op's location in a relatively rural area, and the interests of local news organizations in the Co-op's affairs, it seems sure that the Class would have heard what it now dearly wishes it had heard. Thus, Arthur Young could have satisfied its duty with perhaps two of the ten

> minutes it used to address the annual meetings in 1982 and 1983.

(Ey Pet. App. at 48a (footnote omitted and emphasis added).)

3. The Effect Of The Presumption

The decisions of both courts below on this issue are well-supported by the facts and law. The jury was able to presume that those who bought the Co-op's demand notes would not have invested had they known about Arthur Young's fraud, including the concealed insolvency of the Co-op. Thus, there was no basis in fact, law, or common sense for requiring over 1600 Class members to pour though a courtroom to say "had I known that the Co-op was insolvent, that there was something suspicious about the Co-op's acquisition of the gasohol plant, that the Co-op's auditors failed to follow proper accounting procedures, that the auditors

falsely treated the gasohol plant as if the Co-op always had owned it, and that without this fiction the Co-op would have a negative net worth, I would not have invested all or part of my life savings in demand notes." See, e.g., Mills v. Electric Auto-Lite Co., 396 U.S. 375, 382 n.5 (1970) ("proof of actual reliance by thousands of individuals would . . . not be feasible").

At trial, Arthur Young was given the opportunity to prove that even if it had told the truth at the annual meetings, followed proper accounting procedures, and the like, the Class members would have purchased demand notes anyway. Arthur Young deliberately chose not to rebut the presumption of transaction causation, apparently because there were no facts to support its position.

B. The Eighth Circuit Required The Class To Establish Reliance.

Arthur Young's assertions notwithstanding (EY Pet. at 11), the Eighth Circuit did not ignore the element of transaction causation/reliance.[5] The court merely held that under these particular facts, the Class has established that it was entitled to rely on a presumption of transaction causation, and Arthur Young had to present positive proof to rebut that presumption.

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[5] The commentator that Arthur Young relies on for the proposition that Affiliated Ute and other courts did away with reliance (Ey Pet. at 13 n.6), actually does not support this view. Rather, he asserts that Affiliated Ute replaced a "subjective reliance" test with a "constructive reliance" test. Arnold S. Jacobs, Litigation and Practice Under Rule 10b-5 § 62 n.27, at 3-254 (footnote omitted from EY quotation) and § 64.01[b][i], at 3-314-18 (2d Ed. 1991) ("Ute broadened constructive reliance so it covers all concealment cases").

Arthur Young states that Congress, in enacting section 10(b) of the 1934 Act, intended reliance to be an element of all securities fraud claims. (EY Pet. at 11-12.) But -- as Affiliated Ute itself demonstrates -- Congress never suggested that reliance could not, in certain cases, be presumed to exist subject to the introduction of contrary evidence.

C. The Eighth Circuit Correctly Interpreted Affiliated Ute.

Arthur Young's primary contention on the federal law issue is that the Eighth Circuit and the district court misunderstood Affiliated Ute and therefore misapplied it to these facts. (EY Pet. at 12.) That is not a sufficient reason for the Court to hear this case, and in any event, Arthur Young's argument is unfounded. Arthur Young's interpretation

of _Affiliated Ute_ reads limitations into that decision that no court ever has found.

In _Affiliated Ute_, this Court held that under the circumstances presented there -- where the case primarily was based on nondisclosures and where the defendants had an obligation to disclose -- "positive proof of reliance is not a prerequisite to recovery." 406 U.S. at 153-54. This is exactly the test that the Eighth Circuit applied below: was this primarily a nondisclosure case, and did Arthur Young owe the Class a duty to disclose material facts. Answering both questions in the affirmative, the Eighth Circuit did not require the Class to present "positive proof" of reliance.

Contrary to Arthur Young's claim, nowhere in _Affiliated Ute_ does the Court restrict the presumption to "reliance on omissions of particular facts" to the

exclusion of "reliance on the conduct of defendants." (See EY Pet. at 14.) Arthur Young asserts this limitation is implicit in "the immediately preceding nine pages of the Court's opinion" before the statement of the holding in Affiliated Ute. (Id. at 13-14.) This argument really is a complaint that the presumption of reliance was justified under the facts of Affiliated Ute but not under the facts here. The district court and the court of appeals below both disagreed with Arthur Young.

Arthur Young also claims that the Eighth Circuit relied on a particular passage from Affiliated Ute that it took out of context. (EY Pet. at 13.) This argument is plainly wrong. The Eighth Circuit's decision does not rely on any passage from Affiliated Ute or even cite to that case in its transaction causation analysis. Rather, the court relied on

several Eighth Circuit cases that follow Affiliated Ute and hold that "where the defendant's alleged conduct involves primarily a failure to disclose, the plaintiff need not prove transaction causation will be inferred [subject to rebuttal] if the withheld information is material." (EY Pet. App. at 41a.)

Thus, the Eighth Circuit correctly interpreted the rule in Affiliated Ute and decided, as in Affiliated Ute, the Co-op's auditors could not "stand mute while they facilitate" the fraudulent sale of securities to the Class members. See 406 U.S. at 153.

D. There Is No Conflict Among The Courts Of Appeals.

Arthur Young incorrectly states that there is a conflict among the courts of appeals as to what Affiliates Ute's

presumption of reliance means or when it may be applied. Arthur Young has not cited to any court or commentator that has perceived this alleged conflict. The cases Arthur Young relies on merely demonstrate that the courts of appeals have found that some cases met the Affiliated Ute test while other cases did not.

Arthur Young claims that the Eighth Circuit's decision, along with decisions of the Second, Ninth, and Tenth Circuits from 1975 and 1980, conflict with the Seventh Circuit's interpretation of Affiliated Ute in Latigo Ventures v. Laventhol & Horwath, 876 F.2d 1322 (7th Cir. 1989). (EY Pet. at 17-18.) Yet in Latigo Ventures, the Seventh Circuit did not discuss or attempt to explain Affiliated Ute, and did not disagree with or even cite to the supposedly conflicting

cases. See Latigo Ventures, 876 F.2d at 1326.

Nor did the Eighth Circuit detect any conflict among the circuits over the interpretation of Affiliated Ute. Indeed, the court expressly distinguished Latigo Ventures (and two other cases) because they posed a distinct legal issue and involved dissimilar factual settings:

> [The cases] all involve claims for aiding and abetting Rule 10b-5 violations against accounting firms that did not blow the whistle on their claims, as opposed to the primary Rule 10b-5 liability asserted here. Moreover, those cases feature vastly different factual circumstances and procedural postures.

(EY Pet. App. at 48a n.28.)

E. Summary Of Federal Law Issue

The Eighth Circuit's decision is entirely consistent with congressional intent, Affiliated Ute, and decisions of

other courts of appeals. Arthur Young's only complaint is that the Eighth Circuit reached the wrong result -- in spite of the overwhelming evidence that Arthur Young originated and perpetuated a fraud and, by its deceptions, caused over 1600 investors to purchase worthless securities. This Court should deny Arthur Young's writ on the federal securities law issue.

II. THERE IS NO BASIS FOR THE EXERCISE OF THIS COURT'S SUPERVISORY POWERS HERE.

Arthur Young's liability to the Class is founded on violations of both Rule 10b-5 and the Arkansas Securities Act, and thus, Arthur Young needs both judgments reversed in order to erase its liability. As for Arkansas law, the obstacle Arthur Young faces is that this Court is not the appropriate forum for review of lower federal courts' interpretations of state

statutes. See, e.g., Huddleston v. Dwyer, 322 U.S. 232, 237 (1944) ("[W]e accept and do not review, save in exceptional cases, the considered determination of questions of state law by the intermediate appellate courts." (citation omitted)).

Arthur Young therefore struggles to formulate a procedural issue in order to invoke this Court's supervisory powers. Arthur Young claims that it was unfairly surprised by the Eighth Circuit's allegedly incorrect interpretation of the Arkansas Securities Act. Arthur Young, however, misconstrues the court's decision and merely offers a different interpretation of Arkansas law.

In any event, this Court exercises its supervisory powers only rarely and cases involving serious problems with the administration of justice. Those types of circumstances are not present here.

Indeed, the Eighth Circuit's decision is remarkable for the thorough attention paid to the each of the many issues that were raised on appeal.

A. The Eighth Circuit's Decision

Mindful of this Court's decision in Salve Regina College v. Russell, 111 S. Ct. 1217 (1991), the Eighth Circuit reviewed de novo the district court's decision on the state securities law issue. The court also recognized -- as Arthur Young does not -- that it had to consider the evidence in the light most favorable to the Class, assume that the jury resolved all conflicts of evidence in favor of the Class, assume as true all facts which the Class' evidence tended to prove, and grant the Co-op the benefit of all favorable

inferences that reasonably may be drawn from the facts. (EY Pet. App. at 31a-32a.)

The Eighth Circuit, as the district court had, held that based on all the facts and reasonable inferences, Arthur Young properly was found liable under Ark. Code Ann. § 23-42-106(c), formerly codified as § 67-1256(b) ("section 106(c)").

The court of appeals explained that section 106(c) creates two kinds of secondary liability for securities fraud: control person liability and aiding and abetting liability. The court determined that aiding and abetting liability was more appropriate in light of the facts adduced at trial. (EY Pet. App. at 33a-34a.)

The Eighth Circuit then analyzed the jury instruction on the state securities law claim and concluded that it "fulfilled the requirements of section 106(c)":

> [T]he jury could only hold Arthur Young liable if it concluded that Arthur Young originated the untrue statements or omissions, knew that the statements were communicated to the Class, and knew that the Class would rely on them to purchase the demand notes; in other words, that Arthur Young "materially aided" in the sale of demand notes.

(EY Pet. App. at 36a.)

In fact, the court of appeals held that the district court's instruction set <u>too high</u> a threshold, in that it required the jury to find -- which it did -- that Arthur Young actually originated the securities fraud (and not just materially aided it). The court further held that "the trial evidence provides ample support" for the jury's decision that Arthur Young violated state law. (<u>Id.</u> at 36a-37a.)

B. The Eighth Circuit Made No Factual Findings.

Arthur Young's contention that the Eighth Circuit held it liable under section 106(c) by making an implicit factual finding that it was an "employee" of the Co-op is incorrect. Arthur Young concedes that "the court of appeals did not make an explicit finding" (EY Pet. at 28), and the opinion is bereft of any even an implied decision to that effect.

Arthur Young suggests that it is entitled to a remand to present additional evidence on its liability under Arkansas

law.[6] Yet Arthur Young does not explain what that evidence might be. It was apparent to the courts below that in the course of a four-week trial, the jury was presented with virtually every conceivable detail of Arthur Young's involvement with the Co-op and the demand note program. There are no new facts for Arthur Young to present.

Arthur Young already used the appropriate avenue for relief in this case: a petition for rehearing in the Eighth

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[6] Though Arthur Young also asks this Court for an outright reversal on this issue (EY Pet. at 30), there is no basis for this request. In order to reverse the Eighth Circuit's decision on the state law claim, this Court would have to reinterpret Arkansas securities law. But this Court "lack[s] jurisdiction authoritatively to construe state legislation." United States v. Thirty-Seven Photographs, 402 U.S. 363, 369 (1971) (citation omitted); accord Gooding v. Wilson, 405 U.S. 518, 520 (1972).

Circuit to convince the court to reconsider its interpretation of Arkansas law. The court of appeals denied that petition without dissent.

C. This Court Exercises Its Supervisory Powers Rarely And In Far Different Cases.

Because this Court rarely exercises its supervisory powers over the federal courts, the contours of those powers are not well defined. From the instances in which the Court has used these powers, though, it is plain that there is not a serious problem in the administration of justice that has implications beyond fates of the parties to each case.

For example, in Communist Party of the United States v. Subversive Activities Control Board, 351 U.S. 115 (1956), the Court used its supervisory powers to reverse the circuit court's decision

barring the introduction of additional evidence to show that witnesses had committed perjury at trial: "[F]astidious regard for the honor of the administration of justice requires the Court to make certain that the doing of justice be made so manifest that only irrational or perverse claims of its disregard can be asserted." Id. at 124 (emphasis added).

Other circumstances requiring supervisory action include striking down race-based restrictive covenants, Hurd v. Hodge, 334 U.S. 24, 34 (1948), excluding the introduction of confessions obtained through "flagrant disregard" of criminal justice procedures, McNabb v. United States, 318 U.S. 332, 340-47 (1943), ensuring that district court's attorney residency requirements are consistent with "principles of right and justice," Frazier v. Heebe, 482 U.S. 641, 645-46 (1987), and

preventing a lower court from appointing an interested party as prosecutor in a criminal contempt proceeding, Young v. United States, 481 U.S. 787, 802-09 (1987).

These cases all presented serious and fundamental problems in the administration of justice, with implications reaching far beyond the fates of the parties to each case. These circumstances are not present here. Put in the very best light for Arthur Young, the Eighth Circuit below affirmed a jury verdict and district court decision by interpreting a contested state statute incorrectly and in a manner that Arthur Young had not anticipated. Even if Arthur Young is correct -- and it is not -- the result below does not cause the "honor of the administration of justice" to be questioned. There is no basis for the

exercise of this Court's extraordinary powers of supervision here.

CONCLUSION

For all the reasons stated above, Arthur Young has not presented an issue that merits this Court's consideration, and Ernst & Young's petition for a writ of certiorari should be denied in its entirety.

Respectfully submitted,

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REPLY BRIEF FOR PETITIONER

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REPLY BRIEF FOR PETITIONER

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1. The Class does not dispute the critical fact underlying Arthur Young's Section 10(b) legal argument—the Class has never even alleged, much less introduced evidence at trial, that any Class member heard or saw anything that Arthur Young said or did concerning the Co-op prior to purchasing the Co-op's demand notes. As Arthur Young argued in its petition, to presume reliance on omissions that occurred in statements and documents that the Class does not claim to have listened to, read, or relied on is wholly illogical and would effectively eliminate the reliance requirement in Section 10(b) actions.

Because of the undisputed absence of any indication that Class members could have relied on Arthur Young in making their investment decisions, the lower courts should have rejected the Class' Section 10(b) claims as a matter of law. The lower courts, however, interpreted

Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972), as entitling the Class to a presumption of reliance, even though there was no reason to believe that Class members had in fact relied. This Court should grant Arthur Young's petition in order to affirm that *Affiliated Ute* was not intended to provide the means for such a wholesale circumvention of the reliance requirement in Section 10(b) actions.[1]

a. The Class attempts to divert the Court's attention from Arthur Young's dispositive legal argument by asserting that Arthur Young could have attempted to rebut the presumption of reliance as to each of the more than 1600 Class members at trial. The Court should not be fooled, however, into believing that Arthur Young could have rebutted the presumption by adducing evidence that Class members had not seen Arthur Young's audit reports or heard its oral presentations. The lower courts were well aware that the audit reports were never distributed to the Class members and that only a few hundred persons, not one of which was ever shown to be a member of the Class, attended each of the annual meetings. *See, e.g.*, Pet. App. 16a. Instead, as the Class notes (Opp. Br. 19-20), the relevant issue under the lower courts' interpretation of *Affiliated Ute* was whether the Class members still would have purchased the notes "had they known" of the omitted facts.

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[1] The Class continues to overstate Arthur Young's involvement with the Co-op's activities in its Statement of the Case, which is noteworthy for its lack of any citations to the record. For example, while the Class states that Arthur Young "reviewed and approved" the condensed financial statements prior to the Co-op's 1982 Annual Meeting (Opp. Br. 6), the Eighth Circuit more accurately noted that Arthur Young's representative "received the two condensed financial statements when he arrived at the meeting. He had no advance preparation as to the statement's contents." Pet. App. 16a-17a. Most importantly, however, the Class does not dispute the only fact that is relevant to Arthur Young's legal argument—there is no evidence to suggest that the Class actually relied on Arthur Young in any manner.

Consequently, this "presumption" of reliance is in fact virtually irrebuttable and bears no relation to proof of actual reliance. Plaintiffs in most, if not all, Section 10(b) actions will testify that "had the defendant told them before they purchased what they know now, they never would have invested." Such self-serving, after-the-fact testimony does not, however, provide a nexus between defendant's conduct and plaintiff's investment decision that is even remotely equivalent to actual reliance. The Class' assertion that such testimony should satisfy the reliance requirement in Section 10(b) actions merely serves to highlight Arthur Young's principal contention—the Eighth Circuit's interpretation of *Affiliated Ute* is nothing more than a *de facto* elimination of the reliance requirement and should be rejected by this Court.[2]

b. Contrary to the Class' assertion (Opp. Br. 23), Arthur Young is not attempting to read limitations into this Court's holding in *Affiliated Ute.* Instead, Arthur Young's interpretation of *Affiliated Ute* is based on the entire opinion and not just on one paragraph taken out of context. The opinion finds both that plaintiffs had "relied upon [defendants] when they desired to sell their shares," 406 U.S. at 152, and that "positive proof of reliance is not a prerequisite to recovery." *Id.* at 153. Consequently, either the Court was confused regarding whether reliance was present or it was referring to two different aspects of reliance.

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[2] The Class attempts to explain away a commentator's assertion that the courts "no longer require the element of reliance in 10b-5 concealment cases," 5A A. Jacobs, *Litigation and Practice Under Rule 10b-5*, § 62 at 3-254 (2d ed. 1991 rev.), by arguing that the commentator really meant that "subjective reliance" has been replaced by "constructive reliance." Opp. Br. 21 n.5. A more likely explanation is that the commentator was merely using "constructive reliance" as a euphemism for "no reliance."

Arthur Young submits that the Court was not confused.[3] Rather, because the plaintiffs in *Affiliated Ute* had relied on the conduct of the defendants through their face-to-face dealings, the Court held that positive proof of reliance on the defendants' omissions of particular facts was unnecessary. In sum, there must be some communication between plaintiff and defendant, whether written, oral, or otherwise, on which the plaintiff relied before it is logical to presume that the plaintiff relied on the defendant's omission of a particular fact. Such a link between the Class and Arthur Young is entirely missing in this case.

c. The Class unsuccessfully attempts to distinguish the Seventh Circuit's decision in *Latigo Ventures v. Laventhol & Horwath*, 876 F.2d 1322 (7th Cir. 1989). *Latigo* did, as the Class contends (Opp. Br. 27), deal with aiding and abetting liability of accounting firms, but it also dealt with primary liability. In its discussion of primary liability, the court held that plaintiffs who could not allege that they had read an audit report were not entitled to an *Affiliated Ute* presumption of reliance on omissions that the report was alleged to contain. After citing *Affiliated Ute*, the court noted that "[a]lthough the plaintiffs in this case allege both misrepresentations and deceptive omissions by [the accounting firm], they do not allege that these misleading and deceptive omissions misled or deceived *them*." 876 F.2d at 1326. The Court should affirm this straightforward interpretation of *Affiliated Ute* and reject the contrary interpretations that have been adopted in the Second, Eighth, Ninth, and Tenth Circuits. *See* Petition at 18-19.

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[3] Arthur Young's view that some actual reliance was an important element of *Affiliated Ute* is supported by this Court's discussion of the case in *Chiarella v. United States*, 445 U.S. 222, 230 (1980) (explicitly noting that "the Indian sellers had relied upon [the bank's] personnel when they sold their stock").

2. Contrary to the Class' assertion, Arthur Young is not asking this Court to review the Eighth Circuit's interpretation of the Arkansas Securities Act. Ark. Stat. Ann. § 23-42-106(c). The Arkansas Securities Act could not be any clearer in defining the scope of liability for materially aiding in a sale that violates the Act. Such liability is imposed only on three categories of persons—broker-dealers, selling agents, and employees of the seller. Moreover, the crystal clear statutory language was emphasized by the Arkansas Supreme Court in *Hogg v. Jerry*, 773 S.W.2d 84, 89 (Ark. 1989) ("appellees argue that [defendant] materially aided in the sale of each investment, yet [defendant] meets neither the statutory definition of an employee, an agent, or a broker-dealer"). There is simply no room for interpretation on this point.

Consequently, Arthur Young is not asking this Court to interpret the Arkansas Securities Act, but to review the Eighth Circuit's decision to adopt a theory of liability on appeal that was necessarily based on facts that were not litigated during a four-week trial. Notably, even the Class cannot identify which of the three statutory categories is applicable to Arthur Young. Indeed, with respect to the issue of whether Arthur Young was an employee of the Co-op—the only conceivable category in which Arthur Young could fall—the Class states that the Eighth Circuit's opinion "is bereft of any [*sic*] even an implied decision to that effect." Opp. Br. 33.

The real issue, therefore, is fundamental fairness. Arthur Young has never even been told, much less had an opportunity to litigate, which of the three statutory categories it falls within. Yet the Eighth Circuit held that Arthur Young was liable under the Arkansas Securities Act for a multi-million dollar judgment.[4] It is this most

[4] While Arthur Young believes that the Court should grant review of both issues presented in its petition, granting review only of the Section 10(b) issue could, contrary to the Class' assertion (Opp. Br.

unusual, yet extremely unfair, situation that calls for exercise of the Court's supervisory powers.

For the foregoing reasons and the reasons stated in the petition, the petition for a writ of certiorari should be granted.

Respectfully submitted.

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14), reduce Arthur Young's total liability to the Class. *See* Pet. App. 68a ("the larger net recovery was under the federal securities claim").